Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Refer Reply To:
CC:PSI:B02 – PLR-168671-03
Date:
September 30, 2004

Trust =

Charity =

A =

B =

D1 =

D2 =

D3 =

x =

State =

Dear :

This letter responds to a letter dated October 29, 2003, and subsequent correspondence, submitted on behalf of Trust by Trust's authorized representative, requesting rulings concerning the proposed division of Trust into two separate trusts, Trust A and Trust B.

On D1, A, during his marriage to B, established Trust, a charitable remainder unitrust described in § 664(d) of the Internal Revenue Code. A and B are both residents of State (a community property state). Charity is the charitable beneficiary of the remainder interest and the trustee of Trust. Charity is classified as an organization described in § 501(c)(3) and is a private foundation within the meaning of § 509(a).

Trust provides for annual payments to be made to A during his lifetime of a unitrust amount equal to x percent of the net fair market value of the assets of Trust as of the first business day of each calendar year of Trust. Upon the death of A, the annual payments will be made to B during her lifetime, if she survives A. A, as the grantor of Trust, reserved the power, exercisable only by his Last Will and Testament, to revoke B's interest in Trust.

Trust provides that the lifetime unitrust interest of B will take effect upon the death of A only if B furnishes funds for the payment of any Federal estate tax or state death taxes for which Trustee may be liable upon the death of A.

Upon the death of the last to die of A and B (or solely after A's death if A effectively exercises A's testamentary power to revoke and terminate B's interest), Charity, acting as trustee, will be required to distribute all principal and income to Charity or to such other charitable organization to be designated in accordance with Trust.

On D2, A and B entered into a written property settlement agreement (agreement) which provided for the settlement of their marital property. A divorce decree was also issued on D2 for A and B. On D3, the property settlement agreement was modified in part.

Under the agreement, A irrevocably renounced the power to revoke and terminate B's interest reserved for him in the Trust agreement. The agreement further provided that Trust will be divided into two separate trusts (Trust A) and (Trust B), respectively. The components of principal, ordinary income, capital gain income, and other income of the Trust shall be divided equally between Trust A and Trust B. A shall be the sole non-charitable beneficiary of Trust A and B shall be the sole non-charitable beneficiary of Trust B. Charity will remain as the Trustee of both Trust A and Trust B. A and B will each receive the designated unitrust payment from their respective new trusts. The other terms of Trust will not change for Trust A and Trust B.

Ruling 1

Section 664(c) provides, generally, that a charitable remainder unitrust shall be exempt from federal income tax.

Section 664(d)(2) provides that a charitable remainder unitrust is a trust (A) from which a fixed percentage (which is not less than 5 percent nor more than 50 percent) of the net fair market value of its assets, valued annually, is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in § 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals, (B) from which no amount other than the payments described in § 664(d)(2)(A) and other than qualified gratuitous transfers described in § 664(d)(2)(C) may be paid to or for the use of any person other than an organization described in § 170(c), (C) following the termination of the payments described in § 664(d)(2)(A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in § 170(c) or is to be retained by the trust for such a use or, to the extent the remainder interest is in qualified employer securities (as defined in § 664(g)(4)), all or part of such securities are to be transferred to an employee stock ownership plan (as defined in § 4975(e)(7)) in a qualified gratuitous transfer (as defined by § 664(g)), and (D) with respect to each contribution of property to the trust, the value (determined under § 7520), of such remainder interest in such property is at least 10 percent of the net fair market value of such property as of the date such property is contributed to the trust.

Therefore, based solely on the facts and the representations submitted, the division of Trust into Trust A and Trust B will not cause either Trust, Trust A or Trust B to fail to qualify as charitable remainder trusts under § 664.

Rulings 2 and 3

Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in § 1011 for determining gain, and the loss is the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized. Under § 1001(c), the entire amount of gain or loss must be recognized, except as otherwise provided.

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

An exchange of property results in the realization of gain or loss under § 1001 if the properties exchanged are materially different. Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991). Properties exchanged are materially different if the properties embody legal entitlements "different in kind or extent" or if the properties confer "different rights and powers." Id. at 565. In Cottage Savings, the Court held that mortgage loans made to different obligors and secured by different homes did embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans. Id. at 566. In defining what constitutes a "material difference" for purposes of § 1001(a), the Court stated that properties are "different" in the sense that is "material" to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent. Id. at 564-65.

In this case, prior to the divorce, A owned the entire unitrust income interest in Trust and B had no present interest in either the income or corpus of Trust. B had at most a future continent interest in the unitrust income of Trust. That is, B would have a right to that interest only if (1) A dies without having exercised A's testamentary power to revoke and terminate B's interest in Trust; and (2) B pays any Federal Estate and state death taxes charged to Trust. After the division of Trust pursuant to the property settlement agreement, A's interest decreases to an x percent unitrust amount determined by reference to the 50 percent of the assets of the Trust deposited into Trust A; and B's interest becomes immediate and possessory to an x percent unitrust amount determined by reference to the 50 percent of the assets of Trust deposited into Trust B. Consequently, because after the division of Trust, A's interest declines significantly and B's interest increases significantly, A and B will enjoy legal entitlements that are materially different in kind or extent from those enjoyed prior to the division of Trust. Accordingly, gain or loss would be realized and recognized to A and B under § 1001 unless another section of the Code provides for nonrecognition in such case. See § 1.1001-1(a).

Section 1041(a) provides that no gain or loss will be recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or former spouse if the transfer is incident to the divorce. Under § 1041(b), for purposes of subtitle A, the transferee is treated as having acquired the property by gift from the transferor with a carryover basis from the transferor.

Section 1041 was added to the Code by § 421 of the Tax Reform Act of 1984 (1984 Act), Pub. L. No. 98-369. It provides a broad non-recognition rule for transfers of property between spouses and former spouses. The House Report accompanying the 1984 Act expresses the intent of Congress behind § 1041:

> Furthermore, in divorce cases, the government often gets whipsawed. The transferor will not report any gain on the transfer, while the recipient spouse, when he or she sells, is entitled under the [United States v. Davis, 370 U.S. 65 (1962)] rule to compute gain or loss by reference to a basis equal to the fair market value of the property at the time received.
>
> The committee believes that to correct these problems and make the tax laws as unintrusive as possible with respect to relations between spouses, the tax laws governing transfers between spouses and between former

> spouses should be changed.
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> . . .
>
> The bill provides that the transfer of property to a spouse incident to a divorce will be treated, for income tax purposes, in the same manner as a gift. Gain (including recapture income) or loss will not be recognized to the transferor, and the transferee will receive the property at the transferor's basis . . .. Thus, uniform Federal income tax consequences will apply to these transfers notwithstanding that the property may be subject to differing state property laws.

H. R. Rep. No. 432, 98th Cong., 2d Sess., Part 2, at 1491-92 (1984) (House Report).

For purposes of subtitle A, the Income Tax, § 1041 specifically provides for the nonrecognition of gain or loss on any transfer of property incident to divorce. The broad application of § 1041 is consistent with the above legislative history and applies nonrecognition principles to transfers of property between divorcing spouses if related to the divorce.

Specifically, with respect to the divorce-related transfers of annuities and beneficial interests in trusts, the above legislative history states,

> Where an annuity is transferred, or a beneficial interest in a trust is transferred or created, incident to divorce or separation, the transferee will be entitled to the usual annuity treatment, including recovery of the transferor's investment in the contract (under sec. 72), or the usual treatment as the beneficiary of a trust (by reason of sec. 682),... . Id.

In our view, this statement of Congressional intent supports the application of § 1041's nonrecognition treatment to the facts of this case. Here, prior to divorce, A received annual income from Trust equal to a x percent unitrust amount. B did not receive anything. Pursuant to the agreement, which constitutes a divorce instrument, Trust will be partitioned and divided into two equal trusts, one for A and one for B. Trust A and Trust B each will have 50 percent of the assets of Trust. A and B respectively will each receive income equal to a x percent unitrust amount determined as of the first day of the year from the 50 percent of the assets deposited into their respective trusts (while both are alive). Consequently, A, in essence, is transferring incident to divorce one-half of A's former interest in Trust to B. Consistent with the above legislative history, we conclude that § 1041 will apply to the transfer.

Therefore, for purposes of the income tax, no gain or loss will be recognized by A on the transfer of one-half of A's unitrust interest in Trust to B. B receives that interest as a gift with a carryover basis from A pursuant to § 1041(b). In addition, the pro rata division of Trust into Trust A and Trust B will not result in the recognition of gain or loss to Trust, Trust A, or Trust B for purposes of § 1001.

Ruling 4

Section 1223(2) provides that, in determining the period for which the taxpayer has held property however acquired, there shall be included the period for which such property was held by any other person, if under chapter 1 of the Code such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in the taxpayer's hands as it would have in the hands of such other person.

Section 1015(a) provides, that if property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that if such basis (adjusted for the period before the date of the gift as provided in § 1016) is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value.

Section 1015(b) provides that, if the property was acquired after December 31, 1920, by a transfer in trust (other than by a transfer in trust by a gift, bequest, or devise), the basis shall be the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor on the transfer.

Therefore, based solely on the facts and the representations submitted, Trust A and Trust B will determine their basis in the assets by reference to the basis of the assets in the hands of Trust under § 1015(a) or (b), and the holding periods of the assets held by Trust A and Trust B will include the period for which the assets were held by Trust.

Rulings 5 through 9

Under § 4947(a)(2), §§ 507, 4941 and 4945 apply to certain "split interest" trusts (trusts with both charitable and non-charitable beneficiaries) as if they were private foundations.

Section 507(a) provides that, except as provided in § 507(b), a private foundation may terminate its private foundation status only under the specific rules set forth in

§ 507(a).

Section 507(b)(2) provides that in the case of the transfer of assets of any private foundation to another private foundation pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization or reorganization, the transferee foundation shall not be treated as a newly created organization.

Section 507(c) imposes a termination tax equal to certain defined amounts, which are generally the lower of the "aggregate tax benefit" resulting from the tax exempt status or the fair market value of the assets.

Section 507(d) defines the term "aggregate tax benefit" as one means to measure the § 507(c) tax.

Section 4941(a)(1) imposes an excise tax on each act of self-dealing between a disqualified person and a private foundation.

Section 4941(d)(1)(E) provides that the term "self-dealing" means any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Section 4945 imposes an excise tax on a private foundation's making of any taxable expenditure under § 4945(d).

Section 4946(a) provides the term "disqualified person" with respect to a private foundation includes a substantial contributor to the foundation (including the creator of a trust), and a foundation manager (including a trustee).

Section 4947(a)(2) provides generally that split-interest trusts are subject to the provisions of §§ 507, 4941 and 4945 in the same manner as if such trusts were private foundations, but, under § 4947(a)(2)(A), not with respect to any amounts payable under the terms of such trust to income beneficiaries, unless a deduction was allowed under § 170(f)(2)(B), 2055(e)(2)(B), or 2522(e)(2)(B).

Section 1.507-1(b)(6) provides that if a private foundation transfers all or part of its assets to one or more other private foundations pursuant to a transfer described in § 507(b)(2), such transferor foundation will not have terminated its foundation status under § 507(a)(1).

Section 1.507-3(c)(1) provides that as used in § 507(b)(2), the term "other adjustment, organization or reorganization" shall include any partial liquidation or any other significant disposition of assets to one or more private foundations.

Section 1.507-3(c)(2)(ii) provides that the term "significant disposition of assets" means the transfer of 25% or more of the net assets of the foundation at the beginning of the year, which disposition may be made in a single year or in a series of related dispositions over more than one year.

Sections 1.507-3(a)(1) and (2)(i) provide that in the transfer of assets from one private foundation to one or more private foundations in a § 507(b)(2) transfer, each transferee private foundation shall not be treated as a newly created organization, but shall succeed to the transferor's aggregate tax benefit within the meaning of § 507(d), in proportion to the assets transferred to each.

Section 1.507-3(a)(4) provides that if a private foundation incurs liability for one or more of the taxes imposed under chapter 42 (or any penalty resulting therefrom) prior to, or as a result of, making a transfer of assets described in § 507(b)(2) to one or more private foundations, in any case where transferee liability applies each transferee foundation shall be treated as receiving the transferred assets subject to such liability to the extent that the transferor foundation does not satisfy such liability.

Section 53.4945-6(b)(2) of the Foundation and Similar Excise Taxes Regulations provides that expenditures for unreasonable administrative expenses, including compensation, consultant fees, and other fees for services rendered, will ordinarily be taxable expenditures under § 4945(d)(5) unless the foundation can demonstrate that such expenses were paid or incurred in the good faith belief that they were reasonable and that the payment or incurrence of such expenses in such amounts was consistent with ordinary business care and prudence.

Section 53.4947-1(c)(2)(i) provides that under § 4947(a)(2)(A), § 4941 does not apply to any amounts payable under the terms of a split-interest trust to income beneficiaries unless a deduction was allowed under § 170(f)(2)(B), 2055(e)(2)(B), or 2522(e)(2)(B) with respect to the income interest of any such beneficiary.

Rev. Rul. 2002-28, 2002-20 I.R.B. 1, provides that when a private foundation distributes all of its assets to one or more other foundations under a plan of dissolution, the transferor foundation is not required to exercise expenditure responsibility under § 4945(h) with respect to the transfers.

As a charitable remainder unitrust under § 664(d)(2), Trust is a split-interest trust described in § 4947(a)(2) and, therefore, treated generally as if it were a private foundation. Although split interest trusts are not § 501(c)(3) organizations or

§ 4947(a)(1) private foundations that are exclusively charitable, they are subject to § 507 termination rules that are appropriate. Section 507(b)(2) is applicable to the division of Trust. The transfer of all of Trust's assets, under the D3 modification of A and B's marital settlement agreement, to Trust A and Trust B will qualify as transfers meeting the requirements of § 1.507-3(c)(1) and (c)(2)(ii). Since Trust will transfer all of its assets to Trust A and Trust B, under § 1.507-1(b)(6), Trust will not have terminated its private foundation status as described in § 507(a). Accordingly, under § 1.507-3(a)(1), the two unitrusts will not be treated as newly created private foundations. Also, there will be no imposition of an excise tax under § 507(c).

As discussed above, the transfer is subject to § 507(b)(2) and meets the requirements of § 1.507-3(c)(1) and (c)(2)(ii). Further, Trust A and Trust B shall, under § 1.507-3(a)(2)(i), succeed to the aggregate tax benefit of the transferor organization, the Trust, on a pro rata basis determined by the fair market value of the assets. Under § 1.507-3(a)(4), the assets will be subject to any liability the Trust may have under chapter 42.

A and B are disqualified persons with respect to Trust, under § 4946 because A is a substantial contributor and B was A's spouse at the time of the contribution. The only interest that either A or B had in Trust was the payment of the unitrust amount under the provisions of § 664(d)(2). They have each exchanged a one-half interest in a unitrust payment in Trust (they are in a community property state) for a full unitrust payment in a trust having fewer assets, one-half of the assets of Trust prior to its division. Thus, they are likely to receive the same unitrust payment as before. Section 4941 does not apply to the income interest of both beneficiaries under § 53.4947-1(c)(2). A and B will not receive any additional interest in the assets of Trust's principal, so, no self-dealing transaction should occur under § 4941(d).

Based on the same analysis as applied in the preceding paragraph, Trust is treated generally as if it is a private foundation and consequently subject to § 4945. Following Rev. Rul. 2002-28, 2002-20 I.R.B. 1, since the transferee foundations are treated as the transferor foundation, rather than as recipients of expenditure responsibility grants, there are no expenditure responsibility requirements that must be exercised under § 4945(d)(4) or (h) with respect to the transfers to the transferee foundations. Therefore, the division of Trust into Trust A and B will not result in a taxable expenditure and Trust will not be required to exercise "expenditure responsibility" under §§ 4945(d) and (h) with respect to the assets transferred to Trust A and Trust B.

Trust principal remains preserved for charitable interests. It is represented that there has been no increase in the unitrust amount at the expense of the charitable interest. Following § 53.4945-6(b)(2), legal and other expenses incurred by Trust to implement the division of the assets of Trust, assuming such expenses are incurred in the good faith belief that they are reasonable and consistent with ordinary care and prudence will not constitute taxable expenditures. The expenses incurred by Trust are justified as necessary to facilitate the smooth functioning and operation of Trust, which may not have been possible under the relevant divorce proceedings. There are no other transactions with the income beneficiaries that affect Trust principal. Trust A and Trust B will be controlled by the same person (Charity) who controlled Trust within the meaning of § 1.507-3(a)(9). Subsequently, no self-dealing transaction or taxable expenditure will occur within the meaning of §§ 4941 and 4945 respectively.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts of the transaction described above under any other provision of the Code, in particular § 61. We express no opinion on whether Trust otherwise qualifies as a charitable remainder trust under § 664 or whether the separate trusts each will otherwise qualify as charitable remainder trusts under § 664.

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 sent to Trust's authorized representative.

Sincerely,

Audrey W. Ellis
Reviewer, Branch 2
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

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