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Department of the Treasury
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677.00-00, 678.00-00

Person To Contact:

Telephone Number:

Refer Reply To:

CC:PSI:04-PLR-114181-05

Date: OCTOBER 24, 2005

Re:

Legend:

Grantor =

Spouse =

Trust =

Trustee =

Date =

B =

C =

X =

Y =

Dear :

This is in response to a letter dated March 4, 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).

Article 1, Section 1.1 of Trust provides that during Grantor's life, the trustee may distribute as much income and principal of Trust to Spouse and Grantor's issue as the trustee determines.

Article 1, Section 1.2 provides that at Grantor's death, the trustee shall distribute the trust property to Grantor's issue per stirpes. If none of Grantor's issue survive Grantor, the trustee will retain the trust property in further trust in accordance with section 1.1. If neither Grantor's spouse nor any issue of Grantor survive Grantor, the trustee shall distribute the trust property to Foundation.

Article II provides, generally, that Spouse shall have the right to withdraw an amount equal to the value of each contribution; provided, however, that in no event shall the aggregate value of property subject to this withdrawal right exceed the amount of annual exclusion from gift tax prescribed under section 2503(b) then available to the Grantor with respect to Grantor's spouse for each such calendar year. Upon the receipt of a contribution subject to this right, the trustee shall give Spouse notice of Spouse's right to withdraw. The right to withdraw with regard to a contribution terminates upon the later of 30 days after the receipt of such notice and December 31st of such calendar.

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. For purposes of the section, 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 X shares of B stock, a publicly traded company to Trust in exchange for Y shares of C stock (also a publicly traded company), that is 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 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 X shares of B stock to Trust in exchange for Y 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), the 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 proposed 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
Associate Chief Counsel
(Passthroughs and Special
Industries)

Enclosure: Copy for section 6110 purposes

cc: