

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

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CC:DOM:P&SI:3 PLR-100145-00

Date:

April 26, 2000

M:

N:

P:

Trust:

Company:

LLCs:

State:

a:

b:

Dear

This letter responds to \_\_\_\_\_ letter, dated December 28, 1999, as well as subsequent correspondence, submitted on behalf of M and N (the "taxpayers"), requesting various rulings on the proper treatment of the Trust under §§ 671, 2056, 2511, and 2702 of the Internal Revenue Code. The taxpayers represent the following facts.

The Trust is an irrevocable grantor retained annuity trust of which M is the grantor and annuitant. The annuity provided to M is intended to be a qualifying interest under § 2702. N is the beneficiary of a nonqualifying lifetime income interest in Trust assets which will commence upon expiration of the Trust annuity term. Upon the later of the death of M or N, Trust corpus will pass to grantor's issue.

PLR-100145-00

The Trust owns 100 percent of Company, a State limited liability company, which in turn owns interests in the LLCs.

M executed and funded the Trust on a by transferring his interests in the LLCs to Company. He designated P as trustee. The Trust instrument provides that the trustee shall not accept additional contributions to the Trust.

Under Article First of the Trust instrument, the trustee is to hold the property for a period of 18 years beginning on a or until M's earlier death. The trustee is to pay to M an annual annuity amount equal to 8.78% of the fair market value of the Trust property as of a. The first payment is due on b.

Under Article Second, paragraphs (a) and (c), the annuity amount shall be paid to M in quarter-annual payments. To the extent that income is not sufficient to pay the annuity amount for any tax year, it shall be paid from principal and, in the discretion of the trustee, may be paid in kind.

Under Article Second, paragraph (d), if the net fair market value of the Trust property is incorrectly determined, then within a reasonable period after the value is finally determined for federal tax purposes, the trustee shall pay to M (in the case of undervaluation) or receive from M (in the case of overvaluation) an amount equal to the difference between the annuity amount properly payable and the amount actually paid. Under paragraph (f), any income earned by the Trust prior to the termination date which is in excess of the annuity amount and which is not paid to M shall be added to the principal of the Trust.

Under Article Second, paragraph (e), the annuity amount for a short tax year, including the initial year and the year in which the termination occurs, shall be prorated on a daily basis for the number of days making up the short tax year or for the period from the beginning of the tax year to the termination date.

Under Article Second, paragraph (g), from the date of the creation of the trust through the termination date, there shall be no distributions from the Trust to or for the benefit of any person other than M.

Under Article Second, paragraph (h), M's interest shall not be subject to commutation. Under paragraph (j), the trustee shall not issue a note, other debt instrument, option, or other similar financial arrangement in satisfaction of the annuity amount.

Under Article Third, if M dies before the end of the annuity term, the annuity amount payable will be pro-rated to the date of his death and paid to his estate. The

PLR-100145-00

trustee will pay the balance of all accumulated income and principal of the Trust to M's estate. The taxpayers represent that the value of M's reversionary interest in Trust income and corpus is 12.12 percent of the value of the Trust as of Trust inception.

Under Article Fourth, M may, in a nonfiduciary capacity, acquire the Trust assets by substituting property of equivalent value. M may, at any time and from time to time during the term, demand and receive from the trustee all or any amount of the income of the Trust in excess of the amount necessary to pay the annual annuity amount.

The Trust instrument further provides that, if both M and N survive the 18-year term and are not divorced or legally separated, an amount equal to the annuity amount is to be paid to N for life. N may demand the income of the Trust in excess of the amount necessary to pay the annual annuity amount.

On N's death, if M is still living, or if M survives the 18-year term but N does not, the trustee is to pay the income of the Trust to M's issue per stirpes. In the case of issue under age 21, the income is to be paid as required for education, maintenance and support or as advisable. In addition, the trustee may pay to or for a beneficiary such principal as advisable. At M's death or at N's death, as the case may be, the principal is to be distributed as follows. The trustee may pay up to ten percent to "charitable organizations." The remaining Trust property will be distributed per stirpes to or for M's issue.

Section 671 provides, in general, that if the grantor or another person is treated as the owner of any portion of a trust, that person's taxable income and credits shall include the income, deductions, and credits of the trust attributable to that portion of the trust to the extent that these items are considered in computing the taxable income or credits of an individual.

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

Section 673 provides that 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 the reversionary interest exceeds 5 percent of the value of the trust portion. Section 673(c) provides that, for purposes of § 673(a), the value of the grantor's reversionary interest shall be determined by assuming the maximum exercise of discretion in favor of the grantor.

Section 1.671-3(a)(1) of the Income Tax Regulations provides that if a grantor or another person is treated as the owner of an entire trust (corpus as well as ordinary

PLR-100145-00

income), he takes into account in computing his income tax liability all items of income, deduction, and credit (including capital gains and losses) to which he would have been entitled had the trust not been in existence during the period he is treated as the owner. Section 1.671-3(a)(2) provides that if the portion treated as owned consists of specific trust property and its income, all items directly related to that property are attributable to the portion.

Section 1.671-3(b)(3) provides that both ordinary income and other income allocable to corpus are included by reason of an interest in or a power over both ordinary income and corpus, or an interest in or a power over corpus alone which does not come with the provisions of § 1.671-3(b)(2). For example, if the grantor is treated under § 673 as the owner of a portion of a trust by reason of a reversionary interest in corpus, both ordinary income and other income allocable to corpus are included in the portion.

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

Section 1.1001-1(a) provides, in general, 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 as loss sustained.

In Rev. Rul. 85-13, 1985-1 C.B. 184, the grantor of a trust acquired the entire trust corpus in exchange for his unsecured promissory note. The Service held that such a transaction caused the grantor to be treated as the owner of the trust and consequently, of the trust property. As a result, the transfer of trust assets to the grantor was not a sale for federal income tax purposes.

Section 2702(a)(1) provides that, solely for purposes of determining whether a transfer of an interest in trust 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 interest in the trust retained by the transferor or any applicable family member (as defined in § 2701(e)(2)) is determined as provided in § 2702(a)(2).

Section 2702(a)(2)(A) provides that the value of any retained interest that is not a qualified interest is treated as being zero. Section 2702(a)(2)(B) provides that the value of any retained interest that is a qualified interest is determined under § 7520.

Under § 2702(b), the term "qualified interest" means (1) any interest that consists of the right to receive fixed amounts payable not less frequently than annually, (2) any interest which consists of the right to receive amounts which are payable not less

PLR-100145-00

frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually), and (3) any noncontingent remainder interest if all of the other interests in the trust consist of interests described in § 2702(b)(1) or (2).

Section 25.2702-3(b) sets forth the requirements that must be satisfied for an interest to be a qualified annuity interest. Section 25.2702-3(b)(1)(i) provides that a qualified annuity interest is an irrevocable right to receive a fixed amount. The annuity amount must be payable to (or for the benefit of) the holder of the annuity interest for each taxable year of the term. A right of withdrawal, whether or not cumulative, is not a qualified annuity interest.

Section 25.2702-3(b)(1)(ii) provides that a fixed amount means (A) a stated dollar amount payable periodically, but not less frequently than annually, but only to the extent that the amount does not exceed 120 percent of the stated dollar amount payable in the preceding year; or (B) a fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes, payable periodically but not less frequently than annually, but only to the extent that the fraction or percentage does not exceed 120 percent of the fixed fraction or percentage in the preceding year.

Section 25.2702-3(b)(1)(iii) provides that an annuity interest does not fail to be a qualified interest merely because the trust permits income in excess of the amount required to pay the annuity to be paid to or for the benefit of the holder of the qualified annuity interest. Nevertheless, the right to receive excess income is not a qualified interest and is not taken into account in valuing the qualified annuity interest.

Section 25.2702-3(b)(2) provides that if the annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust property, the governing instrument must contain provisions meeting the requirements of § 1.664-2(a)(1)(iii) (relating to adjustment for any incorrect determination of the fair market value of the property in the trust).

Section 25.2702-3(b)(3) provides that the governing instrument must contain provisions meeting the requirements of § 1.664-2(a)(1)(iv) (relating to the computation of the annuity amount in the case of short tax years and the final tax year of the term). Solely for purposes of § 25.2702-3(b), the governing instrument meets the requirements of § 25.2702-3 with respect to short tax years, if any, and the final tax year of the term if the governing instrument provides that the fixed amount or a pro rata portion thereof must be payable for the final short period of the annuity interest.

Section 25.2702-3(b)(4) provides that the governing instrument must prohibit

PLR-100145-00

additional contributions to the trust.

Section 25.2702-3(d)(1) provides that in order to qualify as a qualified annuity interest, an interest must be a qualified annuity interest in every respect. To be a qualified interest, the interest must meet the definition of and function exclusively as a qualified interest from the creation of the trust.

Section 25.2702-3(d)(2) provides that the governing instrument must prohibit distributions from the trust to or for the benefit of any person other than the holder of the qualified annuity interest during the term of the qualified interest.

Section 25.2702-3(d)(3) provides that the governing instrument must fix the term of the annuity interest. The term must be for the life of the term holder, for a specified term of years, or for the shorter (but not the longer) of those periods. Successive term interests for the benefit of the same individual are treated as the same term interest.

Section 25.2702-3(d)(4) provides that the governing instrument must prohibit commutation (prepayment) of the interest of the term holder.

Section 2036(a) provides that the value of the gross estate includes 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, 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 effect 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 therefrom.

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 an 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 (in whatever capacity exercisable) by the decedent to alter, amend, revoke, or terminate.

Based solely on the facts as represented by the taxpayers in this ruling request, we rule that—

1. M shall be considered the owner of the entire corpus of the Trust for purposes of § 671 until the earlier of his death or the end of the annuity

PLR-100145-00

term.

2. No gain or loss shall be recognized by M on the transfer of his LLC interests to the Trust, on any transfer from the Trust to M in payment of the annuity, or on the substitution by M of his assets for assets of the Trust.
3. The periodic payments to M constitute a “qualified interest” and a “qualified annuity interest” under § 2702(b) and § 25.2702-3. M’s right to demand and receive Trust income in excess of the amount necessary to pay the annual annuity amount will not constitute a “qualified interest” or “qualified annuity interest.”
4. The present value of the gift to the remaindermen equals the fair market value of the property transferred to the trust as finally determined for federal gift tax purposes less the present value of M’s qualified annuity interest (the right to receive the annuity for a period of 18 years or M’s earlier death). The present value of the qualified annuity interest is the actuarial value determined in accordance with § 7520.
5. By the terms of the Trust, if M survives the annuity term, his entire interest in the Trust terminates. Accordingly, if M survives the annuity term, the value of the Trust property will not be includible in his gross estate for federal estate tax purposes.

Except for the specific rulings above, no opinion is expressed or implied concerning the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, we express or imply no opinion concerning the value of the property transferred to the Trust.

In accordance with the power of attorney on file with this office, we are sending a copy of this letter to the taxpayers.

This ruling is directed only to the taxpayers who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,  
WILLIAM P. O’SHEA  
Chief, Branch 3  
Office of Assistant Chief Counsel  
(Passthroughs and Special Industries)

enclosure: copy for § 6110 purposes