Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

Telephone Number:

Refer Reply to: OP:E:EP:T:1

Date:

DEC 29 1998

Legend:

Individual A =
Individual B =
State Y =
Trust X =
Custodian M =

Dear :

This is in response to a ruling request submitted on your behalf by your authorized representative in a letter dated December 3, 1997, regarding the federal income tax consequences of a proposed rollover of a distribution from a decedent's estate to an individual retirement account ("IRA").

The following facts and representations have been submitted on your behalf:

Individual B died at the age of 72 on January 29, 1997. Individual A is the surviving spouse of Individual B. Both Individual A and Individual B were residents of State Y at the time of his death. Individual B appointed Individual A executor under his will, which is a pour-over will. The dispositive document in his estate plan is a revocable living trust (Trust X). All property owned at death by Individual B was community property.

Section 1.03 of Trust X designates Individual A and Individual B as co-trustees, to be succeeded by Individual A as sole trustee after the death of Individual B. Section 3.02, paragraph 2, of Trust X, requires that gifts totaling four hundred thousand dollars ($400,000.00) be distributed to the children of Individual B if he is the first spouse to die. The same section mandates that, after the distribution of such gifts, the trust corpus, including all property distributed to Trust X by the pour-over will, is to be divided into separate trusts designated as the Survivor's Trust and the By-Pass Trust.

Section 3.03 of Trust X provides that the trustee of Trust X shall act as trustee of the Survivor's Trust and the By-Pass Trust. Section 3.05 of Trust X provides that the By-Pass Trust consist of a sum, comprised of that portion of the trust representing all or a portion of the deceased spouse's separate property and all or a portion of the deceased spouse's community property interest which equals the value of the maximum amount of the unified credit available to the deceased spouse's estate, adjusted for taxable gifts or other dispositions that do not qualify for the marital deduction made by the Deceased Spouse, plus an amount equal to certain administrative expenses. Section 3.04 of Trust X provides that the Survivor's Trust shall be comprised of all assets not allocated to the By-Pass Trust, including the balance of the deceased spouse's interest in community property and the surviving spouse's community property interest in Trust X.

Under section 3.06 of Trust X, Individual A, as surviving spouse, must be paid all income from the Survivor's Trust. Section 3.07 provides that the trustee may also pay principal to the surviving spouse from the Survivor's Trust, and section 1.10 allows the trustee to amend, revoke, or terminate the Survivor's Trust, thus giving Individual A, the trustee, complete access to all assets of the Survivor's Trust. Section 3.06 provides that the trustee in her discretion may pay income from the By-Pass Trust to or for the benefit of the surviving spouse. Section 3.08 provides that principal distributions from the By-Pass Trust are limited to the amount deemed necessary by the trustee for the health, education, support and maintenance of the surviving spouse. The By-Pass Trust may not be amended, revoked or terminated.

Sections 3.02 and 5.03 of Trust X give the trustee broad powers to allot, divide, and partition Trust X. The trustee has no obligation to make a pro rata division; instead the trustee may, in the trustee's discretion, make a non-pro rata division between trusts, as long as the respective assets allocated to separate trusts have equivalent or proportionate fair market values.

Among the assets that Individual B owned as community property at date of death was an individual retirement account (IRA), maintained by Custodian M. The taxpayer represents that the IRA satisfies the requirements described under section 408(a) of the Internal Revenue Code. The named beneficiary of the IRA is Trust X.

It has been represented in the ruling request that State Y permits non-pro rata distributions from Trust X to the Survivor's Trust and the By-Pass Trust. It has been represented further, in supplemental letters to the ruling request, that, under the proposed distribution, the assets remaining after allocation of the IRA to the Survivor's Trust that would be allocated to the By-Pass Trust are sufficient to fully fund the unified credit and Individual B's applicable expenses pursuant to the terms of the Trust.

Individual A proposes the following:

1. As sole successor trustee to Trust X, Individual A will allocate the assets of the IRA entirely to the Survivor's Trust.

2. Upon receipt of a favorable ruling from the Internal Revenue Service Individual A will withdraw the 1997 minimum required distribution from the decedent's IRA and distribute it to the Survivor's Trust.

3. As surviving trustor and successor trustee of the Survivor's Trust, Individual A will distribute the assets of the IRA from the Survivor's Trust to herself as surviving spouse. Such distribution will exclude the amount of the 1997 minimum required distribution.

4. As surviving spouse Individual A will place the assets into an IRA in her own name within sixty (60) days of distribution from the decedent's IRA.

It has been represented that, during the one-year period ending on the date of the distribution of the IRA assets to Trust X, there will have been no other tax-free rollover from an IRA through Individual A.

Based on the above facts, Individual A requests the following three-part letter ruling:

1) In making a non-pro rata allocation from Trust X to the successor Trusts and the pre-division gifts, a sale or exchange does not occur under section 1001 of the Code, and, thus, the non-pro rata allocation of the IRA to the Survivor's Trust does not result in a taxable transfer.

2) Individual B's IRA does not represent an inherited IRA to the surviving spouse within the meaning of section 408(d)(3)(C) of the Code.

3) Pursuant to section 408(d)(3)(A)(i) of the Code, Individual A will not be required to include in income for federal income tax purposes for the year in which Individual B's IRA was distributed the amounts received and reinvested in Individual A's IRA so long as such reinvestment is accomplished within 60 days from the date of distribution from the IRA to Trust X.

With regard to the first ruling requested, section 61(a)(3) of the Code provides that gross income includes gains derived from dealings in property.

Section 1001 of the Code 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 section 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) 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."

Rev. Rul. 69-486, 1969-2 C.B. 159, holds that a non-pro rata distribution of trust corpus in kind by mutual agreement of the beneficiaries is subject to gain or loss treatment under section 1001 of the Code. The trust instrument cited in the ruling did not contain a provision allowing the trustee to make a non-pro rata distribution and local law did not convey authority on the trustee to make a non-pro rata distribution of property in kind. Where neither the trust instrument nor local law convey authority on the trustee to make a non-pro rata distribution, the beneficiaries are viewed as having an absolute right to a ratable in-kind distribution. Accordingly, the distribution was equivalent to a ratable distribution to the beneficiaries followed by an exchange between the beneficiaries that was subject to section 1001.

Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), concerns the issue of when a sale or exchange has taken place that results in realization of gain or loss under section 1001. In Cottage Savings, a financial institution exchanged its interests in one group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans. The two groups of mortgages were considered "substantially identical" by the agency that regulated the financial institutions.

The Supreme Court in Cottage Savings, 499 U.S. at 560-561, concluded that section 1.1001-1 of the regulations reasonably interprets section 1001(a) of the Code and stated that an exchange of property gives rise to a realization event under section 1001(a) if the properties exchanged are "materially different."

In defining what constitutes a "material difference" for purposes of section 1001(a) of the Code, the Court stated that properties are "different" in the sense that is "material" to the Code so long as their respective possessors enjoy legal entitlement that are different in kind or extent. Cottage Savings, 499 U.S. at 564-565. In Cottage Savings, 499 U.S. at 566, 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 the loans.

It is consistent with the Supreme Court's opinion in Cottage Savings to find that the proposed non-pro rata distribution of assets to the By-Pass Trust and the Survivor's Trust will not differ materially from the required funding pursuant to the terms of Trust X so as to give rise to a realization event under section 1001(a) of the Code. The provisions of Trust X require that the By-Pass Trust be funded with so much of Individual B's one-half of community property, there being no separate property, as is required to fund the unified credit and pay for Individual B's applicable expenses, with the remainder going to the Survivor's Trust. It has been represented that Individual A's one-half of community property is sufficient in amount to fully fund the unified credit and pay for Individual B's applicable expenses. Accordingly, the proposed distribution does not give rise to a realization event under section 1001(a).

In addition, the present case is distinguishable from Rev. Rul. 69-486 because it has been represented that Trust X and the applicable state law authorize the Trustee to make a non-pro rata distribution of property. Thus, the By-Pass Trust and Survivor's Trust are not required to receive pro rata distributions for each asset of Trust X. Accordingly, the proposed transaction will not be treated as a pro rata distribution followed by an exchange of assets between the ByPass Trust and Survivor's Trust.

We conclude that the proposed distribution, whereby Individual A, as sole Trustee of Trust X, makes a non-pro rata allocation of the IRA to the Survivor's Trust, is not a taxable event under section 1001 of the Code.

With regard to the second and third rulings requested, section 408(d)(1) of the Code provides, in general, that except as otherwise provided in section 408(d), any amount paid or distributed from an IRA shall be included in gross income by the payee or distributee, as the case may be.

Section 408(d)(3) of the Code provides that section 408(d)(1) does not apply to a rollover contribution if such contribution satisfies the requirements of sections 408(d)(3)(A) and 408(d)(3)(B).

Section 408(d)(3)(A)(i) of the Code provides that section 408(d)(1) does not apply to any amount paid or distributed out of an IRA to the individual for whose benefit the account is maintained if the entire amount received (including money and any other property) is paid into an IRA (other than an endowment contract) for the benefit of such individual not later than the 60th day after the day on which she receives the payment or distribution.

Section 408(d)(3)(B) of the Code provides that section 408(d)(3)(A) does not apply to any transfer described in section 408(d)(3)(A)(i) if, at any time during the one-year period ending on the day of such receipt, such individual received any other amount described in such subparagraph from an IRA which was not includible in her gross income because of the application of section 408(d)(3).

Section 408(d)(3)(E) of the Code provides, generally, that section 408(d)(3) shall not apply to any amount to the extent such amount is required to be distributed under either section 408(a)(6) or 408(b)(3).

Section 408(d)(3)(C)(i) of the Code provides, in pertinent part, that, in the case of an inherited IRA, section 408(d)(3) shall not apply to any amount received by an individual from such account (and no amount transferred from such account shall be excluded from income by reason of such transfer), and such inherited account shall not be treated as an IRA for purposes of determining whether any other amount is a rollover contribution.

Section 408(d)(3)(C)(ii) of the Code provides that an IRA shall be treated as inherited if the individual for whose benefit the account is maintained acquired such account by reason of the death of another individual, and such individual was not the surviving spouse of such other individual. Thus, a surviving spouse for whose benefit the account is maintained and who acquired IRA proceeds from and by reason of the death of her husband, may elect to treat those IRA proceeds as her own and roll them over into her own IRA.

Q&A A-4 of section 1.408-8 of the Proposed Income Tax Regulations provides that the only IRA beneficiary of an individual who may elect to treat the beneficiary's entire interest in the trust (or the remaining part of such interest if distribution thereof has commenced to the beneficiary) as the beneficiary's own account is the individual's surviving spouse. If the surviving spouse makes such an election, the spouse's interest in the account would then be subject to the distribution requirements of section 401(a)(9)(A) of the Code, rather than those of section 401(a)(9)(B).

Furthermore, Q&A A-4 provides, an election will be considered to have been made by the surviving spouse if either (1) any required amounts in the account (including any amounts that have been rolled over into an individual retirement account for the benefit of such surviving spouse) have not been distributed within the appropriate time period applicable to the decedent under section 401(a)(9)(B) of the Code, or (2) additional amounts are contributed to the account (or to the account to which the surviving spouse has rolled such amounts over) which are subject to the distribution requirements of section 401(a)(9)(A). The result of such an election is that the surviving spouse shall then be considered the individual for whose benefit the trust is maintained.

Q&A A-6 of section 1.408-8 of the Proposed Regulations provides that, in the case of a rollover to an IRA of an amount distributed by a qualified plan or another IRA, if the surviving spouse of an employee rolls over a distribution from a qualified plan, such surviving spouse may elect to treat the IRA as the spouse's own IRA in accordance with the provisions in A-4. In the event of any other rollover to an IRA amounts rolled over to a plan must be separately accounted for and the minimum distribution with respect to such amounts must be separately determined.

Generally, if a decedent's IRA proceeds pass through a third party, e.g. a trust, and then are distributed to the decedent's surviving spouse, said spouse will be treated as acquiring them from the third party and not from the decedent. Thus, generally, said surviving spouse will not be eligible to roll over the IRA proceeds into her own IRA.

However, in a situation where the surviving spouse has the power to allocate the assets as well as the power to revoke the trust, and cause the assets of the trust to revert to himself or herself, then, for purposes of section 408(d)(3) of the Code, the Service will treat the surviving spouse as having acquired the IRA proceeds from the decedent and not from the trust.

In this case, Trust X is the beneficiary of Individual B's IRA. Subsequent to the death of Individual B, Individual A, Individual B's surviving spouse, became the sole trustee of Trust X. Pursuant to the provisions of Trust X, Individual A, as the surviving trustee, has the sole and uncontrolled discretion to allocate Trust X assets to either the Survivor's Trust or the By-Pass Trust created under the provisions of Trust X. Individual A intends to allocate Individual B's IRA to the Survivor's Trust. Pursuant to the provisions of the Survivor's Trust, Individual A, as trustee, has the power to pay the principal of the Survivor's Trust to herself as Individual B's surviving spouse, and also has the power to terminate the Survivor's Trust. Individual A, as trustee, will pay the IRA assets, less an amount sufficient to satisfy the required distribution rules for 1997, to herself as Individual B's surviving spouse. Individual A will then roll over the IRA distribution into an IRA set up and maintained in her name. Said rollover will occur within 60 days of the date the IRA assets were distributed to Trust X.

Under these circumstances, we do not believe that the general rule above should apply. In such a situation, for purposes of section 408(d)(3) of the Code, the Service will treat the surviving spouse as having acquired the IRA from the decedent and not from the trust.

Thus, with respect to your second and third ruling requests, we conclude that Individual A's IRA account does not represent an inherited IRA within the meaning of section 408(d)(3)(C) of the Code; and that, pursuant to section 408(d)(3) of the Code, Individual A is not required to include in income for federal tax purposes proceeds of Individual B's IRA which will be transferred to an IRA in her own name within 60 days after the date of the distribution from Individual B's IRA to Trust X.

This ruling letter is based on the assumption that both Individual A's IRA and Individual B's IRA satisfy the requirements of section 408(a) of the Code at all relevant times.

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

Sincerely yours,

John Swieca

John Swieca
Chief, Employee Plans
Technical Branch 1

Enclosures:
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Notice 437

cc:

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