

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:DOM:P&SI:4-PLR-115988-98

Date:

December 13, 1999

Re:

LEGEND

- Donor =
- Trust =
- TIN:
- Company 1 =
- Company 2 =
- Trustee 1 =
- Trustee 2 =
- Trustee 3 =
- Father =
- Cousin 1 =
- Cousin 2 =
- Father-in-law =
- Organization 1 =
- Organization 2 =
- Child 1 =
- Child 2 =
- Child 3 =

:

This is in response to your letter of November 20, 1999, and prior correspondence, in which you requested rulings concerning the income, gift, estate, and generation-skipping transfer tax consequences of a proposed partition of a trust.

Donor created Trust in 1969. Trust's corpus consists primarily of stock in Corporation. Trust is irrevocable and Trustee 1, Trustee 2, and Trustee 3 are the current co-trustees of Trust.

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Section 3.02 of the Trust provides the trustees with the discretion to distribute income or principal. Section 3.02 also provides that amounts of net income, capital gains or other proceeds or amounts of principal not paid out to a beneficiary are to be accumulated and added to principal. Except for the payments to charitable beneficiaries, a payment of income or principal is to be made only “among” members of the lowest numbered class defined in § 3.03(1) of the Trust that, at the time of the payment, has one or more living individual beneficiaries. Such payment among the members of the class of individual beneficiaries and charitable beneficiaries need not be equal either at the time of payment or at any future time and may be to one, to all, or to any number of members of any class (with no right, vested or otherwise, on the part of any individual beneficiary or charitable beneficiary to claim any benefit at any time against the trustees or the trust estate) all determined by the trustees in their sole discretion.

Section 3.03 provides that the payments of income or principal may be made to any one or more members of the lowest numbered of the classes of individual beneficiaries described in § 3.03(1) that has one or more representatives then living and/or to any one or more members of the class of charitable beneficiaries described in § 3.03(2).

Section 3.03(1) lists the potential beneficiaries. Section 3.03(1)(i) provides that the Class One beneficiaries include Donor’s issue, then living, all spouses of the then living issue of Donor and all spouses of then deceased issue of Donor.

Section 3.03(1)(ii) provides that the Class Two beneficiaries are the issue of Donor’s father, Father, who are then living, and all spouses of then living issue of Father, and all spouses of then deceased issue of Father, and the issue of Cousin 1, deceased, who are then living, all spouses of then living issue of Cousin 1, and all spouses of then deceased issue of Cousin 1, and the issue of Cousin 2, deceased, who are then living, all spouses of then living issue of Cousin 2, and all spouses of then deceased issue of Cousin 2.

Section 3.03(1)(iii) provides that the Class Three beneficiaries are the issue of Donor’s father-in-law, Father-in-law, who are then living, all spouses of then living issue of Father-in-law, and all spouses of then deceased issue of Father-in-law.

Section 3.03(1)(iv) provides that the Class Four beneficiaries are the persons who would be determined to be the heirs-at-law of the last survivor of all members of Class One who leave heirs then living; or, if there are no such heirs, then such heirs of the last survivor of Class Two who leaves heirs then living; or, if there are no such heirs, then such heirs of the survivor of Class Three who leaves heirs then living.

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Section 3.03(1)(v) provides that the Class Five beneficiaries are the employees, directors, and officers of Company 1 and Company 2 or any subsidiary or successor corporations.

Section 3.03(2) provides that the potential charitable beneficiaries are corporations, associations, and institutions that are organized and operated exclusively for religious, charitable, literary, and educational purposes and are described in § 501(c)(3) of the Internal Revenue Code. In addition, Organization 1 and Organization 2 are specified as potential charitable beneficiaries.

Section 3.03(4) provides that the discretionary powers of distribution of principal and income shall be broad enough to permit complete distribution of all the trust assets at any time.

Section 4.01 provides that, if the trust is not terminated sooner, it shall terminate twenty-one years after the death of the survivor of all persons described in § 3.03(1) as potential individual beneficiaries in all of Classes One to Three, inclusive as such person would be determined as of the date the Trust was executed. At that time, the trust is to be distributed in the discretion of the trustees to any member of the class of individual beneficiaries and charitable beneficiaries then eligible to receive distributions.

Section 4.02 provides that any trustee or any beneficiary or other person may disclaim or renounce, in whole or in any part or portion, any interest, right, power or discretion by written instrument filed with the trustee. In the event of any renunciation or disclaimer of any interest in the trust, the interest disclaimed is to be disposed of in the manner provided for or permitted under the trust as though the interest did not exist. In the event of any renunciation or disclaimer of any power, duty, privilege or discretion by any trustee, the same is to cease to exist, unless otherwise expressly provided in the instrument of disclaimer or renunciation, not merely as to the person renouncing the same, but also as to any successor and forever.

Section 5.04(9) provides the trustees with the authority to divide the trust and to determine values and designate particular assets to a beneficiary. Section 5.04(9) also authorizes the trustee to assign like or unlike properties to different beneficiaries or trusts, to create or hold undivided interests in any property of the trust, and to make distributions and payments in cash or in kind or both.

The trustees propose to divide the Trust into three separate trusts, one trust for the benefit of each of Donor's three children, Child 1, Child 2, and Child 3 and their respective issue. The trusts are to be known as the Child 1 Family Trust, the Child 2 Family Trust, and the Child 3 Family Trust. Trustee 1 will be the initial trustee of the Child 1 Family Trust and all of the dispositive terms of the Child 1 Family Trust will be identical to Trust except that the trustee will not be permitted to make distributions from the Child 1 Family Trust to Child 2, her spouse, her issue or any spouse of her issue

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and to Child 3, his spouse, his issue or any spouse of his issue until the death of the last survivor of Child 1, his spouse, his issue and any spouse of his issue. Thus, distributions will be limited to Child 1 and his family and charitable beneficiaries described in the governing instrument of Trust. If not sooner terminated, then on the death of the last survivor of Child 1, his spouse, his issue, and any spouse of his issue, the Child 1 Family Trust will terminate and will be divided equally between the Child 2 Family Trust and the Child 3 Family Trust as are then in existence, if any.

Trustee 2 will be the trustee of the Child 2 Family Trust and all of the dispositive terms of the Child 2 Family Trust will be identical to Trust except no trustee will be permitted to make distributions from the Child 2 Family Trust to Child 1, his spouse, his issue or any spouse of his issue and to Child 3, his spouse, his issue or any spouse of his issue until the death of the last survivor of Child 2, her spouse, her issue, and any spouse of her issue. Thus, distributions will be limited to Child 2 and her family and charitable beneficiaries described in the governing instrument of Trust. If not sooner terminated, then on the death of the last survivor of Child 2, her spouse, her issue, and any spouse of her issue, the Child 2 Family Trust will terminate and will be divided equally between the Child 1 Family Trust and the Child 3 Family Trust as are then in existence, if any.

Trustee 3 will be the trustee of the Child 3 Family Trust and all of the dispositive terms of the Child 3 Family Trust will be identical to Trust except no trustee will be permitted to make distributions from the Child 3 Family Trust to Child 1, his spouse, his issue or any spouse of his issue and to Child 2, her spouse, her issue or any spouse of her issue until the death of the last survivor of Child 3, his spouse, his issue and any spouse of his issue. Thus, distributions will be limited to Child 3 and his family and charitable beneficiaries described in the governing instrument of Trust. If not sooner terminated, then on the death of the last survivor of Child 3, his spouse, his issue, and any spouse of his issue, the Child 3 Family Trust will terminate and will be divided equally between the Child 1 Family Trust and the Child 2 Family Trust as are then in existence, if any.

All of three trusts must terminate, in all events, no later than the date prescribed in § 4.01 of Trust (discussed above). On termination, the corpus will be distributed at the discretion of the trustees to any member of the class of individuals and charitable beneficiaries then entitled to receive distributions from that trust.

In addition to the partition, each of the trustees will enter into an operating agreement (Operating Agreement) that will govern the administration of the stock in Company 1 held by each partitioned trust. Donor will also become a party to the agreement. The Operating Agreement provides that, following the division of Trust, the trustees intend to coordinate certain of their activities in order to preserve the equity and voting position with respect to the stock in Company 1 that was held by Trust before the division.

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Paragraph 2 of the Operating Agreement provides that all of the voting rights associated with the shares of Company 1 held by the trusts shall be exercised as follows:

- a. All of the Company 1 stock held in the trusts shall be voted as a block in connection with any matter coming before the shareholders of Company 1.
- b. The voting of the block in connection with any matter coming before shareholders of Company 1 shall be determined according to the following procedures:
 - (i) For each of the trusts there shall be determined the number of votes associated with the shares of Company 1 held by the Trust that may be cast in connection with such matter coming before the shareholders of Company 1. The sum of the trust votes for the trusts is referred to herein as the aggregate votes.
 - (ii) A majority of the aggregate votes shall control how the block is voted. For such purposes, the trustee of a trust shall have a number of votes equal to the trust votes for such trust.

Paragraph 5 of the Operating Agreement provides that no trust shall sell, exchange, distribute or otherwise transfer during any calendar year more than 3.5 percent of Company 1 stock held by the trust at the beginning of the year without the approval of the trustees of the other trusts. In addition, any sale shall be subject to the provisions of Paragraph 6 of the Operating Agreement.

Paragraph 6 provides that any trust wishing to sell or exchange any Company 1 stock (or any distributee from any Trust who wishes to sell any stock that was at any time held by any of the trusts), whether to a "Permitted Transferee" or a "non-Permitted Transferee" as defined in Article 10 of the Bylaws of Company 1 shall give advanced written notice thereof to the Trusts and all issue of Donor who will have options to acquire the stock. Afterwards, the parties described in Paragraph 6(a) and 6(b) shall have the option to purchase the shares of stock to the maximum extent allowed by Article 10 of the Bylaws of Company 1. The shares may be purchased at a price equal to the lesser of the per-share price in the purchase offer and the value per share determined by an appraisal on behalf of the ESOP of Company 1.

Paragraph 6(a) provides that the child of Donor for whose family the Trust that has proposed to sell or exchange the stock in Corporation is primarily administered or that previously distributed the stock to a distributee who has proposed to sell or exchange the stock, shall have first option purchase the shares. If the child is not living, the issue of the child shall have the first option to purchase the shares on a per-stirpital

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basis. Any such option may be assigned in whole or in part by its holder to any issue of the child, any trust that has one or more issue of the child as its primary beneficiaries, or any other entity that is directly or indirectly controlled by one or more such issue.

Paragraph 6(b) provides that to the extent that the first option provided for in Paragraph 6(a) is not exercised within 30 days after the provision of notice as required above, then the trusts, other than the trust that has proposed to sell or exchange the Company 1 stock or that previously distributed Company 1 stock to a distributee who has proposed to sell or exchange the Company 1 stock, shall each have the second option to purchase one-half the remaining portion of the stock, and, if one such trust does not exercise its second option to purchase the remaining portion of the stock within 30 days of the expiration of the first option, the other trust shall have the option to purchase the remaining portion of the stock within 30 days of the expiration of the second option.

Paragraph 6 further provides that, if all of the preceding options are not exercised with respect to the Company 1 stock within the time allotted, the proposed sale or exchange may proceed at the price and on the terms and conditions stated in the bona fide purchase or exchange offer but must be completed within 150 days after the notice required in the paragraph above. Donor agrees to exercise any authority that he may have under Article 10 of the Bylaws of Company 1 (discussed below) to preserve the order of priority of the options set forth in the Operating Agreement.

Article 10 of Company 1's Bylaws pertains to the sale of Company 1 stock to a "non-Permitted Transferee." If any shareholder transfers or attempts to transfer any shares of common stock to a non-Permitted Transferee, the transfer gives rise to certain the purchase options. Article 10 lists the individuals that have the option to purchase the stock and also lists the order and time that the option may be exercised. Generally, the family member who is most closely related to the transferee has the first option to purchase the stock. If the family member fails to exercise the option within the allowed time, other more remote family members have the right to purchase the stock and, if they fail to purchase the stock, Company 1 has the right to purchase the stock. If Company 1 fails to purchase the stock, the stock may be sold to a non-Permitted Transferee. If Donor is classified as a "transferor" as that term is defined in Article 10, he can specify a different priority with respect to the order of the parties that may exercise the option to purchase the stock. Under the bylaws, Donor is classified as a transferor and, therefore, has the power to modify the priority of the rights of first refusal.

The trustees have represented that there have been no additions to Trust after September 25, 1985.

The trustees have requested the following rulings:

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1. The proposed division will not cause any distribution from, or termination of any interests in, the Trust to be subject to the generation-skipping transfer tax under § 2601 of the Internal Revenue Code.

2. The proposed division will not cause the Trust, the Family Trusts or any beneficiary to recognize any gain or loss from a sale or other disposition of property under § 61 or § 1001.

3. The proposed division will not cause any beneficiary to be considered as having made a taxable gift and will not constitute a taxable gift to any beneficiary under § 2501.

4. The basis and holding periods in each asset transferred to the Family Trusts from the Trust will, for tax purposes, be the same as the Trust's basis and holding period in each such asset at the time of transfer under §§ 1015 and 1223.

5. The Donor's participation as a party to the Operating Agreement is not a retained right or power within the meaning of §§ 2036 and 2038.

Ruling Request 1

Section 2601 imposes a tax on every generation-skipping transfer made by the "transferor" to a "skip person." Section 2611 defines a generation-skipping transfer as a taxable termination, a taxable distribution, or a direct skip.

Section 1433(b)(2)(A) of the Tax Reform Act of 1986 (the Act), 1986-3 (Vol. 1) C.B. 1, and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations provide that the generation-skipping transfer tax (GSTT) shall not apply to any generation-skipping transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added).

Section 26.2601-1(b)(1)(ii)(A) provides that any trust in existence on September 25, 1985, will be considered an irrevocable trust except as provided in §§ 26.2601-1(b)(ii)(B) or (C), which relate to property includible in a grantor's gross estate under §§ 2038 and 2042. In the present case, the Trust is considered to have been irrevocable on September 25, 1985, because neither § 2038 nor § 2042 apply.

Section 26.2601-1(b)(1)(iv) provides that if an addition is made after September 25, 1985, to an irrevocable trust which is excluded from chapter 13 (the generation-skipping transfer tax) by § 1433(b)(2)(A) of the Act, a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the provisions of chapter 13.

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A modification of a trust that is otherwise exempt from the generation-skipping transfer tax under the Act will generally result in a loss of its exempt or "grandfathered" status if the modification changes the quality, value, or timing of any powers, beneficial interests, rights, or expectancies originally provided for under the terms of the trust.

In the present case, Trust will be partitioned into three trusts, one trust for the benefit of each child of Donor and that child's family. Trust currently has three trustees, Trustee 1, Trustee 2, and Trustee 3, and under the plan of partition, each of the current trustees will be a trustee of one of the partitioned trusts. With respect to the stock in Company 1 held by the partitioned trust, the sale of this stock will be governed by the terms of the Operating Agreement.

Trust was irrevocable on September 25, 1985, and the trustees of Trust have represented that there have been no additions (constructive or otherwise) to Trust after September 25, 1985. Under § 3.03(4), the trustees have broad discretionary power to distribute or accumulate income and principal of the Trust among the beneficiaries defined in § 3.03(1) of the trust agreement. Furthermore, § 5.04(9) provides the trustees with the authority to divide the trust and to determine values and designate particular assets to a beneficiary. Section 5.04(9) also authorizes the trustee to assign like or unlike properties to different beneficiaries or trusts, to create or hold undivided interests in any property of the trust, and to make distributions and payments in cash or in kind or both.

Based on the facts submitted and the representations made, we conclude that the proposed division will not alter the quality, value or timing of interests under the original Trust, will not confer any additional powers or beneficial interests upon any of the beneficiaries, and will not create any additional generation-skipping transfers or increase the amount of generation-skipping transfers. Accordingly, the proposed division will not cause any distribution from, or termination of, any interests in the Trust to be subject to the generation-skipping transfer tax under § 2601.

Ruling Request 2

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 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 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

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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.

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 § 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 mortgage loans were considered "substantially identical" by the agency that regulated the financial institution.

The Supreme Court concluded that § 1.1001-1 reasonably interprets § 1001(a) and an exchange of property gives rise to a realization event under § 1001(a), if the properties exchanged are "materially different." Cottage Savings, 499 U.S. at 560-561. In defining "materially different" for purposes of § 1001(a), the Court stated that properties are "different" in a sense that is "material" so long as their respective possessors enjoy legal entitlements that are different in kind or extent. Id. at 564-565. The Court held that mortgage loans made to different obligors and secured by different homes embodied distinct legal entitlements, and that the taxpayer realized losses when it exchanged the loans. Id. at 566.

Thus, in order for a transaction to result in a § 1001 taxable event, the transaction must be: (1) a sale, exchange or other disposition; and (2), if an exchange, the exchange must result in the receipt of property that is "materially different" (as defined in Cottage Savings, supra) from the disposed property. In this case, the first element will not be present because the beneficiaries of the Family Trusts do not acquire their interests in those trusts as a result of an exchange of their interests in the Trust, but instead by reason of the authority granted to the trustees of Trust by the Donor at the time Trust was created to divide the trust.

Further, it is represented that Trustee 1, Trustee 2, and Trustee 3 are not related or subordinate parties, within the meaning of Code § 672(c), to the Donor, any of the Donor's issue, or the spouse of any of the Donor's issue. Accordingly, the fact that each new Family Trust will have a sole trustee who was selected by the Donor's child for whose family that Family Trust is primarily administered, will not have any consequences under §§ 61 or 1001. Each sole trustee of a Family Trust will be required to continue to exercise the same standard of fiduciary responsibility as the trustees previously exercised with respect to the Trust.

Finally, the execution of the Operating Agreement by each Family Trust's trustee and the Donor will not have any consequences under §§ 61 or 1001.

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Therefore, the Trust, the three Family Trusts, and the beneficiaries of these trusts will not realize gain or loss under § 1001, or income under § 61, as a result of the proposed transactions.

Ruling Request 3

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.

In this case, the interest of each beneficiary will remain the same after the proposed division except as specifically contemplated in the Trust instrument. Accordingly, based on the facts submitted and the representations made, we conclude that the proposed division will not cause any beneficiary to be considered as making a taxable gift under § 2501.

Ruling Request 4

Section 1015(b) provides that, if a property is acquired 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.

Section 1.1015-2(a) provides that, in the case of property acquired by transfer in trust (other than by a transfer in trust by a gift, bequest, or devise) the basis of property so acquired is 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 upon such transfer under the law applicable to the year in which the transfer was made. In addition, the principles in § 1.1015-1(b) concerning the uniform basis are applicable in determining the basis of property where more than one person acquires an interest in property by transfer in trust. Section 1.1015-1(b) provides that property acquired by gift has a single or uniform basis although more than one person may acquire an interest in the property. The uniform basis of the property remains fixed subject to proper adjustment for items under §§ 1016 and 1017.

Because the proposed division of Trust will not result in the realization of gain or loss under § 1001, or income under § 61, the basis of the assets held in the three separate trusts, the Child 1 Family Trust, the Child 2 Family Trust, and the Child 3 Family Trust, will be the same as the basis those assets would have had in the hands of the trustees of Trust.

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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 purposes of determining gain or loss from its sale by the taxpayer the same basis in whole or in part in the taxpayer's hands as it would have in the hands of the other person.

As noted above, the basis of the assets held by the three partitioned trusts will be the same as the basis would be if Trust continued to hold the assets. Accordingly, under § 1223(2) the holding period of the assets in each of the partitioned trusts will include the holding periods of those assets in Trust.

Ruling Request 5

Section 2036(a) provides that a decedent's 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 any period that 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 therefrom.

Section 2038(a)(1) provides that 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 alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or were any such power is relinquished during the 3-year period ending on the date of the decedent's death.

In this case, as part of the Operating Agreement, Donor has agreed to exercise any authority that he may have under Article 10 of the Bylaws of Company 1 in a manner that will preserve the priority of the options to purchase the shares of Company 1. Under Article 10 of the Bylaws of Company 1, if Donor is classified as the transferor with respect to certain stock of Company and there is an offer to purchase the stock, Donor may specify a different priority with respect to the order of the parties that may exercise the right to acquire the stock. Based on the fact submitted and the representations made, we conclude that Donor's participation as a party to the

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Operating Agreement is not a retained right or power within the meaning of §§ 2036 and 2038.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely yours,

Assistant Chief Counsel
(Passthroughs and Special
Industries)

By _____
George Masnik
Chief, Branch 4

Enclosure (1)
Copy for § 6110 purposes