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Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:4-PLR-103344-99
Date:

February 15, 2000

Re:

Legend

Grantors =

Child A =

Child B =

Child C =

1973 Trusts =

2000 Trusts =

Trustee =

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Dear _____ :

This responds to your letter of October 21, 1999, and prior correspondence, in which you requested rulings concerning the income, estate, and generation-skipping transfer tax consequences of the proposed merger of several trusts.

In 1973, Grantors established the 1973 Trusts for the benefit of their daughters, Child A, Child B, and Child C. Under the power granted in § 2.01(1) of the trust instrument, the trustee, Trustee, divided the trust property into three equal shares, one for each daughter. Each daughter is the primary beneficiary of her share. Each share is to be held and administered as a separate trust for the primary beneficiary and the issue of the primary beneficiary. In dividing the trust estate into separate shares or trusts or in distributing the same, the trust instrument gives the trustee the power to divide or distribute in cash, in kind, or partly in cash and partly in kind, using different properties according to their value and/or undivided interests in the same properties, as the trustee shall think fit. The trustee also has the power, for any purpose, including division or distribution, to value the trust estate or any part thereof reasonably and in good faith.

Section 2.01(2) of the trust instrument grants the trustee the power to accumulate income or to distribute income or principal for the comfort and welfare of the primary beneficiary for whom the trust is named and for the issue of the primary beneficiary.

Section 1.05 of the trust instrument creates a Trust Committee consisting of three individuals. If the membership of the Trustee Committee is reduced to less than three individuals because a member ceases or fails to serve, then the remaining members shall appoint by majority vote a sufficient number of persons to bring the total membership to three individuals. During the lifetime of either Grantor, the Trust Committee may not consist of a membership more than half of whom are parties that are related or subordinate to the Grantors as such terms are defined in § 672(c). Section 1.05 also provides that the Trust Committee, in carrying out its duties, must act in a fiduciary capacity.

Under § 4.04 of the trust instrument, the Trust Committee has the power, in its sole discretion, at any time or times, to remove the trustee and to appoint a successor trustee, but may not appoint any person who is a "related or subordinate party" with respect to the Grantors as that term is defined in § 1.05, above.

Section 2.01(4) of the trust instrument provides that each trust terminates upon the earliest to occur of the following: (1) termination by the Trust Committee; (2) the death of the primary beneficiary and all the issue of such primary beneficiary; or (3) 20 years and 11 months after the death of the last to die of a specified group of individuals who were living at the time the trust was established. On termination, principal and

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undistributed income are to be distributed among the primary beneficiary and any issue of the primary beneficiary as the Trust Committee shall determine in its discretion.

The 1973 Trusts grant the trustee the power to either merge and commingle all of the principal and undistributed income held in any trust created under the 1973 trust instrument with or into any trust created or authorized in any other trust, or may merge and commingle all of the principal and undistributed income in any other trust with any trust created or authorized in the 1973 trust instrument, if the trustee of any trust created or authorized in the 1973 trust instrument is also the trustee of any other trust created or authorized in any will or other trust instrument executed by either or both of the Grantors. This power given to the trustee is exercisable without the consent of the beneficiaries and without judicial consent.

The 1973 Trusts were established prior to and were irrevocable on September 25, 1985. You have represented that there have been no additions to the 1973 Trusts after September 25, 1985, and that no modifications have been made to the 1973 Trusts. You also represent that the Grantors have not established multiple trusts for substantially the same primary beneficiary or beneficiaries with a principal purpose of avoiding income tax.

Grantors propose to establish the 2000 Trusts. Under § 2.01(1) of the trust instrument, the Trustee will divide the assets contributed to the 2000 Trusts in three equal shares, one share for each daughter, and the separate shares will be administered as separate trusts. Each daughter is the primary beneficiary for the separate trust created for her. The Trustee then proposes to merge each daughter's separate share in the 1973 Trusts into the daughter's separate share of the 2000 Trusts.

The 2000 Trusts contain substantially identical dispositive provisions as the 1973 Trusts. Unlike the 1973 Trusts, however, § 1.03 of the 2000 Trusts provides for an investment trustee and an independent trustee. Trustee will serve as the independent trustee for each separate trust and each daughter will serve as the investment trustee of her separate trust. Section 1.04 of the trust instrument provides that the independent trustee shall have the sole authority to exercise certain powers defined as the "tax sensitive powers." Section 1.07 defines "tax sensitive powers" and includes all powers over distribution of income and principal. No trustee has the power to participate in any decision relating to a distribution of either principal or income to provide any benefit for any beneficiary which such trustee is legally obligated to support. The 2000 Trusts cannot continue beyond the perpetuities period that would otherwise apply to the 1973 Trusts.

The Grantors have represented that they intend to allocate sufficient generation-skipping transfer tax exemptions to the 2000 Trusts to cause the 2000 Trusts to have an inclusion ratio of zero.

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You have requested the following rulings:

1. The proposed merger of the 1973 Trusts into the corresponding 2000 Trusts will not constitute transfers subject to generation-skipping transfer tax under § 2601.
2. Following the proposed merger, each of the 2000 Trusts will thereafter consist of two portions, a non-chapter 13 portion and a chapter 13 portion. The non-chapter 13 portion will represent the value of each of the 1973 Trusts immediately prior to the merger and will have an inclusion ratio of zero. Likewise, any post merger increase in value of the non-chapter 13 portion will continue to have an inclusion ratio of zero.
3. Provided that the Grantors timely allocate their respective generation-skipping transfer tax exemptions to the 2000 Trusts in an amount equal to the fair market value of the original contribution on the date of the contribution and provided that no post merger additions are made to the 2000 Trusts, the inclusion ratio for the chapter 13 portion of the 2000 Trusts will be zero and any generation-skipping transfers from the 2000 Trusts, which are deemed to come pro rata from the non-chapter 13 portion and the chapter 13 portion, will not be subject to generation-skipping transfer tax.
4. No gain or loss under § 1001 will be realized by the 1973 Trusts, the 2000 Trusts, or any of the beneficiaries, as a result of the proposed merger of the 1973 Trusts into the corresponding 2000 Trusts.
5. The assets transferred from the 1973 Trusts to the corresponding 2000 Trusts will have the same basis and holding periods under §§ 1015 and 1223 before and after the merger.
6. The transfer of assets from the 1973 Trusts into the corresponding 2000 Trusts will not constitute an accumulation distribution under § 665.
7. Child A, Child B, and Child C, each acting as an investment trustee of the trust held for her benefit, will not hold a general power of appointment as defined in § 2041 or § 2514.

Ruling Requests Nos. 1 through 3 (Generation-skipping Transfer Tax Consequences)

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 2612(a) provides that a taxable termination means a termination by death, lapse of time, release of a power, or otherwise, of an interest in property held in a trust where the property passes to a skip person. Section 2612(b) provides that a taxable distribution means any distribution from a trust to a skip person other than a

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taxable termination or a direct skip. Section 2612(c) provides that a direct skip means a transfer subject to a tax imposed by Chapters 11 or 12 of an interest in property to a skip person.

In general, under § 2602, the amount of generation-skipping transfer tax imposed on a transfer is equal to the taxable amount multiplied by the “applicable rate.”

Section 2641(a) defines the applicable rate of tax on a generation-skipping transfer to be the product of the maximum federal estate tax rate and the inclusion ratio with respect to the transfer.

Section 2642(a) provides that the inclusion ratio is the excess, if any, of 1 over the applicable fraction determined for the trust from which the transfer is made or, in the case of a direct skip, the applicable fraction determined for the skip. The applicable fraction is a fraction in which the numerator is the generation-skipping transfer tax exemption allocated to the trust, or in the case of a direct skip, allocated to the property transferred, and the denominator is the value of the property transferred to the trust or transferred in the direct skip, reduced by any federal estate tax or state death tax actually recovered from the trust attributable to the property and any charitable deduction allowed under §§ 2055 and 2522 with respect to the property.

Section 2631 provides that, for purposes of determining the inclusion ratio, every individual is allowed a generation-skipping transfer tax exemption of \$1,000,000 which may be allocated by the individual or his executor to any property with respect to which the individual is the transferor.

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 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.

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. If an addition is made, the trust is thereafter deemed to consist of two portions solely for purposes of chapter 13, a portion not subject to

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chapter 13 (the non-chapter 13 portion) and a portion subject to chapter 13 (the chapter 13 portion), each with a separate inclusion ratio. The non-chapter 13 portion represents the value of the assets of the trust as it existed on September 25, 1985. The applicable fraction, as defined in § 2642(a)(2), for the non-chapter 13 portion is deemed to be 1, and the inclusion ratio is 0. The chapter 13 portion of the trust represents the value of all additions made to the trust after September 25, 1985. The inclusion ratio for this portion is determined under § 2642.

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, the 1973 Trusts were irrevocable on September 25, 1985, and you have represented that there have been no additions (actual or constructive) to the 1973 Trusts after September 25, 1985. Under the trust instrument, the Trustee of the 1973 Trusts has broad discretionary power to distribute or accumulate income and principal of the 1973 Trusts. In addition, the Trustee has the authority to merge the trusts and to determine values and designate particular assets to a beneficiary. Furthermore, the Trustee has the power 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 Trustee proposes to transfer the assets held in the 1973 Trusts into the 2000 Trusts. As discussed above, the substantive and dispositive provisions of the 2000 Trusts are identical to those contained in the 1973 Trusts. The changes with respect to the trustee provisions are administrative in nature. Based on the facts submitted and the representations made, we conclude that the proposed transaction will not alter the quality, value or timing of interests under the 1973 Trusts, 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 transaction will not cause any distribution from, or termination of, any interests in the 1973 Trusts to be subject to the generation-skipping transfer tax under § 2601.

As indicated above, the 1973 Trusts are exempt from the generation-skipping transfer tax. After the proposed transaction, in accordance with §§ 26.2601-1(b)(1)(iv), the 2000 Trusts will be treated for purposes of chapter 13, as consisting of two portions, a non-chapter 13 portion, and a chapter 13 portion, each with a separate inclusion ratio. The inclusion ratio with respect to the non-chapter 13 portion will be zero. The inclusion ratio with respect to the chapter 13 portion will be determined under § 2642. It is represented that Grantors intend to allocated a sufficient amount of their generation-skipping transfer tax exemption to the chapter 13 portion so that the portion will have an inclusion ratio of zero for purposes of the generation-skipping transfer tax. Accordingly,

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provided that the Grantors timely allocate their respective generation-skipping transfer tax exemptions to the 2000 Trusts in an amount equal to the fair market value of the original contribution on the date of the contribution and provided that no post merger additions are made to the 2000 Trusts, the inclusion ratio for the chapter 13 portion of the 2000 Trusts will be zero and any generation-skipping transfers from the 2000 Trusts, which are deemed to come pro rata from the non-chapter 13 portion and the chapter 13 portion, will not be subject to generation-skipping transfer tax (assuming the 2000 Trusts are not subject to inclusion in the gross estate of any beneficiary (see ruling request #7 below)). This ruling does not address the inclusion ratio of the 2000 Trusts should additions be made to the trusts after the merger.

Ruling Request No. 4 (Gain or Loss under § 1001)

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) provides that except as otherwise provided in subtitle A of the Code, 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 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

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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 2000 Trusts do not acquire their interests in those trusts as a result of an exchange of their interests in the 1973 Trusts, but instead by reason of the authority granted to the trusts’ Trustee by the Grantors at the time the 1973 Trusts were first created to merge and commingle trust assets.

Ruling Request No. 5 (Basis and Holding Periods of Assets)

Section 1015(b) provides that, if 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 merger of the 1973 Trusts with the 2000 Trusts will not result in the realization of gain or loss under § 1001, or income under § 61, the basis of the assets held in the resulting 2000 Trusts will be the same as the basis of those assets prior to the merger.

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 in the resulting 2000 Trusts will be the same as the basis of those assets prior to the merger. Accordingly, under § 1223(2) the holding period of the assets in the resulting 2000 Trusts will include the holding periods of those assets in the 1973 Trusts.

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Ruling Request No. 6 (Accumulation Distributions under § 665)

Sections 665 through 668 provide rules for the taxation of accumulated income distributions by a trust.

Section 665(b) provides, that for purposes of subpart D, except as provided in § 665(c), the term “accumulation distribution” means, for any taxable year of the trust, the amount by which (1) the amounts specified in paragraph (2) of § 661(a) for such taxable year, exceed (2) distributable net income for such year reduced (but not below zero) by the amounts specified in paragraph (1) of § 661(a).

Section 661(a) provides that in any taxable year there shall be allowed as a deduction in computing the taxable income of an estate or trust (other than a trust to which subpart B applies), the sum of (1) any amount of income for such taxable year required to be distributed currently (including any amount required to be distributed which may be paid out of income or corpus to the extent such amount is paid out of income for such taxable year); and (2) any other amounts properly paid or credited or required to be distributed for such taxable year; but such deduction shall not exceed the distributable net income of the estate or trust.

Section 661(b) provides that the amount determined under § 661(a) shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the estate or trust as the total of each class bears to the total distributable net income of the estate or trust in the absence of the allocation of different classes of income under the specific terms of the governing instrument.

Section 661(c) provides that no deduction shall be allowed under § 661(a) in respect of any portion of the amount allowed as a deduction under § 661(a) (without regard to § 661(c)) which is treated under § 661(b) as consisting of any item of distributable net income which is not included in the gross income of the estate or trust.

Section 665(c)(1) provides, that for distributions in tax years beginning after August 5, 1997, for purposes of subpart D, in the case of a qualified trust, any distribution in any taxable year beginning after the date of the enactment of § 665(c) shall be computed without regard to any undistributed net income.

Section 665(c)(2) defines “qualified trust,” for the purposes of § 665(c) as any trust other than (A) a foreign trust (or, except as provided in regulations, a domestic trust which at any time was a foreign trust), or (B) a trust created before March 1, 1984, unless it is established that the trust would not be aggregated with other trusts under § 643(f) if such section applied to such trust.

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Section 643(f) provides that for purposes of subchapter J, under regulations prescribed by the Secretary, two or more trusts shall be treated as one trust if (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiaries, and (2) a principal purpose of such trusts is the avoidance of the tax imposed by chapter 1.

The Trustee represents that the primary purpose of establishing the 2000 Trusts is to encourage the primary beneficiaries to participate in investment decisions relating to the trust assets. The Trustee further represents that avoidance of income tax is not a primary purpose of the 1973 Trusts within the meaning of § 643(f)(2). Determining whether avoidance of income tax is a primary purpose of the 1973 Trusts is a question of fact, the determination of which must be deferred until the federal income tax returns of the parties involved have been examined by the office of the District Director having examination jurisdiction over the tax returns. Therefore, provided it is not determined that tax avoidance is a primary purpose of the 1973 Trusts, and based solely on the information submitted and representations made, we conclude that the merger of the principal and undistributed income of the 1973 Trusts into the 2000 Trusts is not a distribution under § 661, and that distributions from the 1973 Trusts, or from the 2000 Trusts after the merger, will not be subject to the accumulation distribution rules under § 665.

Ruling Request No. 7 (Inclusion in Gross Estate of Beneficiaries)

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 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 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 other 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 the 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 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 where any such power is relinquished during the 3-year period ending on the date of the decedent's death.

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Section 2041(a)(2) provides that the value of the gross estate shall include the value of all property to the extent of any property with respect to which the decedent has at the time of death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition that is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under §§ 2035 to 2038, inclusive.

Section 2041(b)(1)(A) provides that a general power of appointment is a power that is exercisable in favor of the decedent, the decedent's creditors, or the creditors of the decedent's estate. However, a power to consume, invade, or appropriate property for the benefit of the decedent that is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent shall not be deemed a general power of appointment.

Section 20.2041-1(b) provides that a power in a decedent to remove or discharge a trustee and appoint himself may be a power of appointment. For example, if under the terms of a trust instrument, the trustee or his successor has the power to appoint the principal of the trust for the benefit of individuals including himself, and the decedent has the unrestricted power to remove or discharge the trustee at any time and appoint any other person including himself, the decedent is considered as having a power of appointment. However, the mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment.

Rev. Rul. 95-58, 1995-2 C.B. 191, revoking, Rev. Rul. 79-353, 1979-2 C.B. 325, holds that a decedent-settlor's reservation of an unqualified power to remove a trustee and appoint an individual or corporate successor trustee that is not related or subordinate to the decedent within the meaning of § 672(c), is not considered a reservation of the trustee's discretionary powers of distribution over the property transferred by the decedent-settlor to the trust, for purposes of §§ 2036 and 2038.

In the present case, the Trust Committee has the power to remove and replace the trustee. Child A, Child B, and Child C are not members of the Trust Committee. The trust instrument for the 2000 Trusts designates Child A, Child B, and Child C, as the primary beneficiary of their separate trusts, to be the investment trustee with the power to institute investment guidelines and policies. Child A, Child B, and Child C, in their capacity as investment trustees, are prohibited from exercising certain powers defined in the trust instrument as "tax sensitive powers." In addition, Child A, Child B, and Child C, in their capacity as investment trustees or otherwise, do not have the power to remove or replace the independent trustee. Therefore, we conclude that neither Child A, Child B, nor Child C in their respective capacities as investment trustee

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would be treated as holding a general power of appointment for purposes of § 2041. Therefore, the separate shares created for Child A, Child B, and Child C in the resulting 2000 Trusts would not be included in her respective gross estate as a result of her position as investment trustee of the trust. This ruling is limited to the estate tax consequences if Child A, Child B, and Child C serve as the investment trustee. This ruling does not apply should Child A, Child B, or Child C serve as a member of the Trust Committee.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under the cited provisions or any other provisions of the Code. This ruling is based on the facts and applicable law in effect on the date of this letter. If there is a change in material fact or law (local or Federal) before the transactions considered in the ruling take effect, the ruling will have no force or effect. If the taxpayer is in doubt whether there has been a change in material fact or law, a request for reconsideration of this ruling should be submitted to this office

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(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