

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:7:PLR-112654-98

Date: August 11, 2000

Legend: Date 1:
 Grantor:
 Trust:

Spouse:
Daughter:
Date 2:
Child 1:
Child 2:
Child 3:
Individual 4:
Individual 5:
Individual 6:
Individual 7:
Individual 8:
Individual 9:
Court:

Date 3:
State:

Dear

We received the February 21, 2000, letter requesting rulings concerning the income, estate, gift, and generation-skipping transfer (GST) tax consequences of the proposed division of a trust. This letter responds to that request.

The facts and representations submitted are as follows. On Date 1, Grantor established Trust for the benefit of Spouse and Daughter. Grantor died on Date 2. Spouse is the primary beneficiary of Trust and Daughter is the secondary beneficiary. It is represented that no additions, actual or constructive, have been made to Trust since September 25, 1985.

Daughter's siblings, Child 1, Child 2, and Child 3 are the Trustees of Trust.

Article 2(a) of Trust provides that any amount to be distributed at any time by the Trustees to the secondary beneficiary is to be distributed by the trustees to the secondary beneficiary and the descendants, if any, of the secondary beneficiary in such amounts and upon such divisions as in the discretion of the Trustees are deemed wise to meet the needs and requirements of said beneficiaries from time to time.

Article 2(b) of Trust provides that during the life of Grantor, all income shall be payable to the secondary beneficiary.

Article 2(c) of Trust provides that upon Grantor's death, one-half of the income shall be paid to the primary beneficiary. The remaining one-half of the income shall be distributed between the primary beneficiary and the secondary beneficiary (subject to the provisions of Article 2(a)), in such amounts and upon such divisions as the Trustees deem necessary.

Article 2(d) of Trust provides that upon the primary beneficiary's death, all income shall be paid to the secondary beneficiary and her descendants in accordance with Article 2(a).

Article 6 of Trust provides that the term of Trust shall be for the life of the survivor of the following named individuals: Grantor, Spouse, Daughter, Child 1, Child 2, Child 3, Individual 4, Individual 5, Individual 6, Individual 7, Individual 8, and Individual 9.

Article 7(a) of Trust provides that upon the death of the survivor of Daughter, Child 1, Child 2, and Child 3, all income from Trust shall be divided equally between Grantor's surviving grandchildren with the descendants of a deceased grandchild taking per stirpes the portion of their deceased ancestor and any after-born grandchild *en ciente* at the time of the death of the survivor of the aforesaid Grantor being included as a surviving grandchild.

Article 7(b) of Trust provides that upon the death of the survivor of those named in Section 6, the entire Trust, including both principal and accumulated income, shall be distributed equally to the surviving grandchildren of Grantor with the descendants of a deceased grandchild taking per stirpes the portion of their deceased ancestor.

It is represented that the parties desire to divide Trust into two trusts, Trust 1 and Trust 2, in order to pursue differing investment strategies. In accordance with this plan, one-half of the Trust value shall be allocated to Trust 1, and the other half by value shall be allocated to Trust 2.

Under the terms of the proposed division, the beneficiary of Trust 1 will be Spouse, and all income from Trust 1 is to be distributed to her for her lifetime. The beneficiaries of Trust 2 shall be Spouse, Daughter, and Daughter's descendants. The income of Trust 2 shall be distributed among Spouse, Daughter, and Daughter's descendants in such amounts and upon such divisions as the Trustees may deem necessary.

The term of Trust 1 shall be for Spouse's life. At her death, Trust 1 shall be merged with Trust 2. The term of Trust 2 shall be the same as the term of Trust, and Trust 2 shall terminate under the same provisions as for the termination of Trust.

The Trustees of Trust petitioned Court for an Order authorizing the division. Further, the Trustees sought an Order construing paragraphs 2 and 7(a) of Trust to mean that in the event the four children of Grantor predecease Spouse, all of the provisions and directions found in paragraphs 2(a) through 2(d) of Trust pertaining to the distribution of income to Spouse shall take precedence over the provisions contained in paragraphs 7(a), and that if all four children of Grantor predecease Spouse, none of the income from Trust shall be distributed under the provisions of paragraph 7(a) of Trust until Spouse's death.

On Date 3, Court issued a Decree Construing and Interpreting Certain Trust Provisions and Authorizing Division of Trust and Trust Assets (the "Decree"). In that Decree, Court approved the division of Trust, and construed Paragraphs 2 and 7(a) to mean that in the event that the four children of Grantor predecease Spouse, the provisions of Paragraph 2(a) through 2(d) shall apply and take precedence over the provisions contained in Paragraph 7(a). Court further held that if all four children predecease Spouse, none of the income from Trust is to be distributed under the provisions of Paragraph 7(a) until Spouse's death.

The following rulings are requested:

- (1) The proposed division of Trust into Trust 1 and Trust 2 will not cause the interest of any beneficiary of Trust, Trust 1, or Trust 2 to be includible in such beneficiary's gross estate under § 2033;
- (2) The proposed division of Trust into Trust 1 and Trust 2 will not cause the interest of any beneficiary of Trust, Trust 1, or Trust 2 to be includible in such beneficiary's gross estate under § 2036, 2037, or 2038;
- (3) The proposed division of Trust into Trust 1 and Trust 2 will not cause any beneficiary of Trust, Trust 1, or Trust 2 to have made a taxable gift for purposes of Chapter 12;
- (4) After the proposed division, Trust, Trust 1, and Trust 2 each will be treated as a trust that was irrevocable on September 25, 1985, for purposes of § 1433(b)(2)(A) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, as a trust that remains exempt from the GST tax under

§ 2601, and that no actual or constructive additions to such trusts will result from such proposed division;

(5) Transfers from Trust to Trust 1 and Trust 2 pursuant to the proposed division of Trust and distributions from Trust 1 and Trust 2 to their beneficiaries will not be generation-skipping transfers and will not be subject to tax under § 2601;

(6) The proposed division of Trust into Trust 1 and Trust 2 will not cause Trust, Trust 1, or Trust 2 or any of their beneficiaries to recognize any gain or loss from the sale or other disposition of property under §§ 61 or 1001;

(7) Pursuant to § 1015, the tax basis of Trust 1 and Trust 2 in each property received from Trust in the proposed division of Trust into Trust 1 and Trust 2 will be the same as the tax basis of Trust in such property; and,

(8) Pursuant to § 1223(2), the holding period of the Trust 1 and Trust 2 in each property received from Trust in the proposed division of Trust will include the holding period of Trust in such property.

Ruling Request 1:

Section 2033 provides that the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.

Based on the facts submitted and the representations made, after the proposed division of Trust into separate trusts, Spouse will have an income interest in Trust 1. Further, Spouse, Daughter, and Daughter's descendants will have an income interest in Trust 2. During the term of Trust 1 and Trust 2, none of the beneficiaries will have an interest in the principal of Trust until its termination. At Spouse's death, Trust 1 will terminate and be merged with Trust 2. At the end of the term of Trust 2, Trust 2 will terminate and the principal and accumulated income will be distributed to Grantor's surviving grandchildren. Accordingly, we conclude that the proposed division of Trust into Trust 1 and Trust 2 will not cause the interest of Daughter, Child 1, Child 2, or Child 3 to be includible in such beneficiary's gross estate under § 2033.

Ruling Request 2:

Section 2036 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 consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death — (1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Section 2037 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 after September 7, 1916, 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, if — (1) possession or enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent, and (2) the decedent has retained a reversionary interest in the property (but in the case of a transfer made before October 8, 1949, only if such reversionary interest arose by the express terms of the instrument of transfer), and the value of such reversionary interest immediately before the death of the decedent exceeds 5 percent of the value of such property.

Section 2038 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.

In order for §§ 2036 through 2038 to apply, the decedent must have, at any time, made a transfer of property or any interest therein (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth) under which the decedent retained an interest in, or a power over, the income or corpus of the transferred property. Based on the facts submitted and the representations made, the beneficiaries have a right to income from the property, and no right to distributions of principal under the terms of Trust. Further, on division of the Trust into Trust 1 and Trust 2, each beneficiary will retain the same right to income as that beneficiary had under Trust. Accordingly, we consider that the division of Trust into Trust 1 and Trust 2 will not cause any beneficiary of Trust to be considered to have made a transfer within the meaning of §§ 2036, 2037, or 2038. Because the beneficiaries of Trust, Trust 1, and Trust 2 are not making a transfer within the meaning of §§ 2036, 2037, and 2038, the division of Trust into Trust 1 and Trust 2 will not cause the interest of any beneficiary of Trust, Trust 1, and Trust 2, to be includible in such beneficiary's gross estate under §§ 2036 through 2038.

Ruling Request 3:

Section 2501 imposes a tax for each calendar year on the transfer of property by gift during such calendar year by any individual, resident, or nonresident. Section 2511 provides that, subject to certain limitations, the gift tax applies whether the transfer is in trust or otherwise, direct or indirect, and whether the property transferred is personal, tangible, or intangible.

Upon division of Trust into Trust 1 and Trust 2, each beneficiary will have the same right to income as the beneficiary had under Trust. Because the beneficial interests, rights, and expectancies of the beneficiaries of Trust are substantially the same both before and after the proposed transaction, no transfer of property will be deemed to occur as a result of the proposed division. Based on the facts submitted and the representations made, we conclude that the proposed transaction will not cause any beneficiary of Trust, Trust 1, or Trust 2 to have made a taxable gift for purposes of the gift tax.

Ruling Requests 4 and 5:

Section 2601 imposes a tax on every generation-skipping transfer.

Section 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations provides that the tax does not apply to any generation-skipping transfer under a trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985. The rule of the preceding sentence does not apply to a pro rata portion of any generation-skipping transfer under an irrevocable trust if additions are made to the trust after September 25, 1985.

Section 26.2601-1(b)(1)(ii) provides that, except as provided in § 26.2601-1(b)(1)(ii)(B) or (C), any trust in existence on September 25, 1985, is considered an irrevocable trust.

Section 2611(a) defines the term "generation-skipping transfer" as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 26.2611-1 provides that a generation-skipping transfer is an event that is either a direct skip, a taxable distribution, or a taxable termination. The determination as to whether an event is a generation-skipping transfer is made by reference to the most recent transfer subject to the estate and gift tax.

Section 2612(c)(1) defines the term "direct skip" to mean a transfer subject to a tax imposed by chapter 11 or 12 of an interest in property to a skip person.

Section 2613(a) defines the term "skip person" to mean - -

(1) a natural person assigned to a generation that is two or more generations below the generation assignment of the transferor, or

(2) a trust - -

(A) if all interests in the trust are held by skip persons, or

- (B) if - -
- (i) there is no person holding an interest in the trust, and
 - (ii) at no time after the transfer may a distribution (including distributions on termination be made from the trust to a non-skip person.

An amendment to an exempt trust that modifies or otherwise changes the quality, value, or timing of any of the powers, or beneficial interests, rights, or expectancies originally provided under the terms of the Trust will cause the trust to lose its exemption from the GST tax.

Based on the facts submitted and the representations made, the division of Trust into Trust 1 and Trust 2 will not change the quality, value, or timing of any powers, beneficial interests, rights or expectancies of any beneficiary provided for under the terms of the original trust. It is represented that no additions have been made to Trust since September 25, 1985. Accordingly, Trust, Trust 1, and Trust 2 will be treated as trusts that were irrevocable on September 25, 1985, and as trusts that remain exempt from the generation-skipping transfer tax. No constructive or actual additions will result from the proposed transaction. Transfers to Trust 1 and Trust 2 pursuant to the proposed transaction will not be generation-skipping transfers and will not be subject to tax under § 2601.

Ruling Request 6:

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 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.

A partition of jointly owned property is not a sale or other disposition of property where the co-owners of the joint property sever their joint interests, but do not acquire a new or additional interest as a result thereof. Thus, neither gain nor loss is realized on a partition. See, Rev. Rul. 56-437, 1956-2 C.B. 507.

In Rev. Rul. 69-486, 1969-2 C.B. 159, distinguished by, Rev. Rul. 83-61, 1983-1 C.B. 78, a non-pro rata distribution of trust property was made in kind by the trustee, although the

trust instrument and local law did not convey authority to the trustee to make a non-pro rata distribution of property in kind. The distribution was effected as a result of a mutual agreement between the trustee and the beneficiaries. Because neither the trust instrument nor local law conveyed authority to the trustee to make a non-pro rata distribution, Rev. Rul. 69-486 held that the transaction was equivalent to a pro rata distribution followed by an exchange between the beneficiaries and was subject to the provisions of § 1001 and § 1002 of the Code.

The present case is distinguishable from Rev. Rul. 69-486 because it has been represented that State Code would permit the Trustees to divide the properties of Trust between Trust 1 and Trust 2 in a non-pro rata manner. Thus, Trust 1 and Trust 2 are not required to receive pro rata distributions of each asset of Trust. Accordingly, the proposed transaction will not be treated as a pro rata distribution followed by an exchange of assets among the beneficiaries of Trust.

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 of the Code. 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 institution.

The Supreme Court in Cottage Savings, 499 U.S. at 560-61, concluded that § 1.1001-1 of the regulations reasonably interprets § 1001(a) and stated that an exchange of property gives rise to a realization event under § 1001(a) if the properties exchanged are "materially different."

In defining what constitutes a "material difference" for purposes of § 1001(a), the Court stated that properties are "different" in the sense that is "material" to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent. Cottage Savings, 499 U.S. at 564-65. 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 interests in the loans.

Since Grantor is now deceased, under Trust, one-half of the income is distributed to the primary beneficiary and one-half of the income is distributed by the Trustee among the primary beneficiary, the secondary beneficiary, and the descendants of the secondary beneficiary. Also, under Trust, upon the death of the primary beneficiary, all income will be paid to the secondary beneficiary and the descendants of the secondary beneficiary. Trust 1 will terminate upon the death of the primary beneficiary and its assets will be merged into Trust 2. Trust 2 will terminate at the same time that Trust would have terminated. The termination of Trust 1 upon the death of the primary beneficiary is consistent with the terms of Trust since the assets of Trust 1, upon the death of the primary beneficiary, will be held by Trust 2 for the benefit of the same beneficiaries under the same terms that they would have been held upon the death of the primary beneficiary under Trust.

It is consistent with the Supreme Court's opinion in Cottage Savings, to find that the interests of the beneficiaries of Trust 1 and Trust 2 will not differ materially from their interests in Trust. The proposed transaction will not change the interests of the beneficiaries. Instead, the beneficiaries will be entitled to the same benefits after the proposed transaction as before. The proposed transaction is similar to the kinds of transactions discussed in Rev. Rul. 56-437, since Trust is to be partitioned, but all other provisions of the trusts will remain unchanged, other than changes which reflect the fact that Grantor is no longer living and changes which are necessary to ensure that the beneficiaries will be entitled to the same benefits under Trust 1 and Trust 2 that they would have been entitled to under Trust. Thus, the proposed transaction will not result in a material difference in the kind or extent of the legal entitlements enjoyed by the beneficiaries.

Therefore, the beneficiaries of Trust, Trust 1, and Trust 2 will not realize gain or loss under § 1001 of the Code as a result of the proposed transaction.

Ruling Request 7:

Section 1015(a) of the Code provides that if property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that if such basis (adjusted for the period before the date of the gift as provided in § 1016) is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss, the basis shall be such fair market value.

Section 1015(b) provides that if property was acquired by a transfer in trust (other than a transfer in trust by 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 such transfer.

Section 7701(a)(43) of the Code provides that the term "transferred basis property" means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to the basis in the hands of the donor, grantor, or other transferor.

Based upon the information submitted and representations made, we conclude that because § 1001 will not apply to the proposed partition of Trust, under § 1015(b), the basis of the assets in Trust and in Trusts 1 and 2 after the partition will be the same as the basis of those assets prior to the partition. Therefore, we conclude that the partition of Trust will not alter the status of the assets held in Trust prior to the proposed partition as transferred basis property under §§ 1015 and 7701(a)(43).

Ruling Request 8:

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 the property was held by any other person, if under Chapter 1 of the Code such property has, for the purposes of determining gain or loss from a sale or exchange, the same basis in whole or in part in the taxpayer's hands as it would have in the hands of such other person.

As ruled above, the basis of Trust 1 and Trust 2 in each property received from Trust in the proposed division of Trust into Trust 1 and Trust 2 will be the same as the basis of Trust in such property. Therefore, we conclude that the holding period of Trust 1 and Trust 2 in each property received from Trust in the proposed division of Trust into Trust 1 and Trust 2 will include the holding period of Trust in such property.

Except as specifically ruled herein, we express no opinion as to the consequences of this transaction under the cited provisions of the Code or under 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 law (local or federal) before the transactions considered in this 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 that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Christine E. Ellison, Chief
Branch 7
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures:

Copy for § 6110 purposes