

Internal Revenue Service

Department of the Treasury

Number: **200119047**

Washington, DC 20224

Release Date: 5/11/2001

Index Numbers: 2601.00-00; 61.00-00;
1001.00-00; 2501.00-00

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:Br.7-PLR-109696-00

Date:

February 9, 2001

Legend

Decedent-Grantor:

Trust:

Trustee:

Current Trustees:

A:

B:

C:

D:

Court Order 1:

Court Order 2:

Court:

Settlement Agreement:

State:

m:

n:

o:

p:

date 1:

date 2:

date 3:

date 4:

date 5:

date 6:

date 7:

year 1:

year 2:

year 3:

Dear _____ :

In a letter, dated May 2, 2000, you requested rulings on behalf of A concerning the generation-skipping transfer (GST) tax, income tax and gift tax consequences of the proposed partition of the Trust. This letter responds to your request.

The information submitted and the representations made are summarized as follows: Trust, a testamentary trust, was established for the benefit of A under the will of Decedent-Grantor pursuant to Court Order 1 on date 1. Similar separate testamentary trusts were established for B and C, A's siblings. A and D are the current cotrustees of the Trust.

The terms of the Trust, as construed pursuant to Court Order 1, are summarized as follows:

Trust property is hereby distributed to A's father, as Trustee, in trusts, and he, as Executor, is directed to deliver said property to himself, as trustee, in trusts, subject, however, to full payment of, (whether by direct payment, reimbursement to the Executor, or otherwise) all liens for any taxes and expenses of administration which are unpaid or which may become payable in connection with any such taxes, all of which Trustee is authorized and empowered to pay out of the trusts in his hands. The trust estates are to be held, administered and distributed by him as Trustee for the uses and purposes, upon the terms, and subject to the conditions set forth in the Third, Fourth & Fifth sections of Decedent-Grantor's will and the codicils thereto, and is construed by Court, as follows:

Court Order 1 states that one-third of the trust estate shall be set aside in a separate trust for the benefit of Decedent-Grantor's son, A (or his lawful living issue as hereinafter set forth). Trustee shall pay to A each year, or within sixty days after the end of each such year, during his lifetime from the net income of Trust during each such year an amount equal to the difference between the aggregate amounts, if any, which he shall receive during each such year from all trusts established by Decedent-Grantor, during her lifetime or established by her husband, A's father, during his lifetime, which may be in effect at the time of the death of Decedent-Grantor and of which A is a beneficiary and the sum of \$m.

Court Order 1 states that each of Decedent-Grantor's children, A, B and C, is a primary beneficiary of his or her respective trust and that each trust is to be held, administered and distributed in accordance with the following paragraphs:

Subparagraph 1, of Court Order 1 states that the amounts payable to each primary beneficiary shall be paid to the respective primary beneficiary in one lump sum or in payments or installments, in the discretion of Trustee.

Subparagraph 2, Section I of Court Order 1 states that if at any time, in the absolute discretion of Trustee, any of the primary beneficiaries should for any reason be in need of funds for his or her proper care, comfort, health, support, maintenance, recreation, and education, Trustee may, in his absolute discretion, pay to or apply for the use and benefit of any such primary beneficiary, in addition to the amounts hereinabove provided to be paid to such primary beneficiary, such amounts from the income of such primary beneficiary's respective trust in excess of the amounts distributable to such primary beneficiary in accordance with the foregoing, or from the principal of such primary beneficiary's respective trust, up to the whole thereof, as Trustee may from time to time deem necessary for such purpose.

Subparagraph 3, Section I of Court Order 1 states that the balance of the net income of any trust being held for the benefit of any primary beneficiary hereunder and not distributed to the respective beneficiary thereof in accordance with the foregoing provisions of this section shall be accumulated by Trustee and shall become part of the principal of the respective trust estate.

Subparagraph 4, Section I of Court Order 1 states that should any primary beneficiary die leaving surviving him or her lawful issue, then the respective trust above provided for the benefit of such primary beneficiary shall nevertheless remain in effect for the benefit of the lawful living issue of such primary beneficiary, and Trustee shall pay to or apply for the use and benefit of such issue, from said trust estate, in quarterly or other convenient installments, so much of the income and principal of such trust as Trustee in his absolute discretion deems necessary for the care, comfort, health, support, maintenance, recreation, and education of such issue, taking into account other income of such issue. Any income not so distributed to or for the benefit of such

issue shall be added to and become part of the principal of said trust. Upon the decease of all such issue, the said trust estate or the portion thereof then remaining shall go in equal shares to augment the remaining trust estate or estates herein established or provided for then being held for the benefit of the other primary beneficiaries, including any trust being administered for the benefit of the then living lawful issue of any primary beneficiary who shall then be deceased.

Subparagraph 5, Section I of Court Order 1 states that should any primary beneficiary die leaving surviving him or her no lawful issue, the trust above provided for the benefit of such primary beneficiary shall terminate and the trust estate then remaining shall go in equal shares to augment the trust estate or estates herein established or provided for and then being held for the benefit of the other primary beneficiary or beneficiaries, including any trust being administered for the benefit of the then lawful issue of any primary beneficiary who shall then be deceased.

Subparagraph 6, Section I of Court Order 1 states that whenever the interest of any beneficiary in net income or principal hereunder shall terminate, either by reason of death or otherwise, all amounts thereof accrued or undistributed by the Trustee at the date of such termination shall be held in trust for the benefit of or shall be distributed to the beneficiary or beneficiaries entitled to the next successive interest hereunder in like manner as is provided in this section with respect to the principal of the trust theretofore held for such beneficiary whose interest so terminates.

Subparagraph 7, Section I of Court Order 1 states that upon the death of the last to die of the primary beneficiaries and their lawful issue, and provided A's father is then living, A's father shall have the right for and during a period of three years from and after the date of the death of the last to die of such persons to distribute, if he is a trustee, or if he is not a trustee, to direct the then acting trustee to distribute the property and assets comprising the trust estates, free from the trusts, in such amounts and proportions as he may in his absolute discretion determine to one or more of the following: (a) The heirs at law of the primary beneficiaries and their lawful issue as determined according to the laws of State relating to the succession of separate property in effect at the date of the death of the last to die of such persons but excluding A's father if he shall be included among such heirs, and (b) any charitable organization or organizations recognized as such for income tax purposes. The direction above provided to be given by A's father to the then acting trustee shall be in writing and shall be binding upon the trustee.

Subparagraph 7, Section I of Court Order 1 further states that upon the death of the last to die of the primary beneficiaries and their lawful issue, any property and assets then or thereafter comprising the trust estates and not distributed or distributable pursuant to the foregoing provisions of this Division shall go and be distributed, free from the trusts, to the heirs at law of Decedent-Grantor, as determined according to the laws of State relating to the succession of separate property in effect at the date of the death of the last to die of such persons but excluding A's father if he shall be included among such heirs.

Subparagraph 9, Section I of Court Order 1 states that notwithstanding the foregoing provisions of this Section, each trust herein established or provided for shall, unless sooner terminated under the foregoing provisions of this Section, terminate upon the death of the last survivor of Decedent-Grantor's children, A, B, C, and her husband, A's father. Upon such termination the respective assets and properties then comprising each said respective trust shall go and be distributed, free from the respective trust, to the then living lawful issue of the deceased primary beneficiary of such trust on the principle of representation, or should there be no such lawful issue of such primary beneficiary then living, to the lawful living issue of the other primary beneficiaries on the principle of representation, or should there be no lawful issue of the other primary beneficiaries then living, to the heirs at law of Decedent-Grantor as determined according to the laws of State then in effect relating to the succession of separate property.

Subparagraph 10, Section I of Court Order 1 states that the term issue as used herein shall include legally adopted as well as natural children, and the issue of any legally adopted or natural child.

Trusts were retroactively amended by court order on date 2 to provide that any beneficiary of the trusts who is also a trustee will not participate in the exercise of the discretion to invade principal for his or her benefit. This discretion is to be exercised solely by the corporate cotrustee. The court order was issued subject to the receipt of a favorable letter ruling from the Internal Revenue Service regarding the federal estate and GST tax consequences of the Trust amendment. A favorable ruling was issued on date 3.

Trustee, A's father, served as the sole trustee of the trusts for A, B and C for approximately n years, until his powers were suspended by court order on date 4. Beginning with year 1, Trustee had been making regular discretionary distributions of principal and income to A for A's benefit until his powers were suspended on date 4. At that time, A and D were named as temporary successor cotrustees of the trusts, and were subsequently appointed Current Trustees of the trusts pursuant to court order on date 5. D made distributions to A from year 2 through year 3 of approximately \$o annually. Trustee died on date 6.

On date 7, p of A's children, alleging abuse of trustee discretion by making excessive discretionary distributions to A and by investing to produce more income and less growth and thus favoring the income beneficiary, filed objections to one of the accounts filed with Court by the Current Trustees. The p children also questioned whether p of the other children, who were adopted by A were qualified to take shares of Trust and objected to the amount of Current Trustees' fees and attorneys' fees paid from Trust.

After several court hearings, significant discovery, court-ordered mediation with

two different mediators, and months of extensive negotiations, the parties to the litigation agreed, subject to Court approval, to settle their various claims and disputes regarding the administration of Trust and the interpretation of certain terms of the governing instruments.

Under the Settlement Agreement, which was approved by Court in Court Order 2 subject to obtaining a favorable ruling from the Internal Revenue Service, Trust will be divided into five separate equal successor trusts, successor trusts 1 through 5, for each of A's children, including the adopted children, who will be named as the presumptive remainder beneficiary of one of the successor trusts. All assets and liabilities of Trust will be divided on an in-kind pro-rata basis with fractional shares and odd lots of securities sold and with the cash proceeds therefrom divided among the five successor trusts to ensure equal division.

The Settlement Agreement also provides for three trustees for each of the successor trusts. Under the Settlement Agreement, A will have the power to name and remove the first trustee for each of the five successor trusts, and A may serve as the first trustee in successor trusts 3 through 5. The presumptive remainder beneficiary of each successor trust will have the power to name and remove the second trustee of that beneficiary's successor trust. The first and second trustees acting together will have the power to appoint the third, corporate trustee of each successor trust. Either the first trustee or the second trustee may unilaterally remove the corporate trustee acting in the third trustee position with or without cause on thirty days written notice to the other trustees, provided that this unilateral power cannot be exercised more than once in any twelve month period by any trustee or his or her predecessors serving in the same trustee position. If the power is exercised, the trustee in the other position who did not exercise the power to remove the corporate trustee will appoint the successor corporate trustee. If that trustee fails to appoint a successor corporate trustee, the Court will appoint a successor corporate trustee to act in the third trustee position. All administrative expenses incurred by a trustee of any of the successor trusts will be paid from the trust estate of such successor trust on behalf of which the expenses were incurred. The trustees of each successor trust are authorized to invest the assets of such successor trust primarily for growth, without regard to the production of income.

During his lifetime, distributions from successor trusts 1 to 5 may be made only to A. From successor trusts 1 through 3, A will obtain a distribution equal to a specific percentage of the fair market value of the assets of each such trust as of the last business day of the prior calendar year without regard to his other income, financial resources, or personal assets.

From successor trusts 4 and 5, at the discretion of the corporate trustee, A may obtain a support distribution from income or principal, or both. To obtain it, he must submit a written summary statement to the corporate trustee reflecting the amounts he

spent for his support from all sources, during the prior calendar year.

You have requested the following rulings:

1. The division of Trust into five successor trusts and the implementation of the administrative changes to Trust pursuant to Court Order 2 approving Settlement Agreement will not cause the continuing trusts to lose their exempt status for generation-skipping transfer tax purposes as grandfathered trusts.
2. The division of Trust into five successor trusts and the implementation of the administrative changes to Trust pursuant to Court Order 2 approving Settlement Agreement will not constitute a sale, exchange, or other disposition of Trust assets and will not require the recognition of any gain or loss for income tax purposes.
3. The division of Trust into five successor trusts and the implementation of the administrative changes to Trust pursuant to Court Order 2 approving Settlement Agreement will not constitute any taxable transfer for gift tax purposes.

Ruling No. 1:

Section 2601 imposes a tax on every generation-skipping transfer (within the meaning of subchapter B).

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

Section 2612(a)(1) provides that the term "taxable termination" means the termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in a trust unless--(A) immediately after the termination, a non-skip person has an interest in the property, or (B) at no time after the termination may a distribution (including distributions on termination) be made from the trust to a skip person. Section 2612(b) provides that the term "taxable distribution" means any distribution from a trust to a skip person (other than a taxable termination or a direct skip). Section 2612(c)(1) provides that the term "direct skip" means a transfer subject to a tax imposed by chapter 11 or 12 of an interest in property to a skip person.

Section 2613(a) provides that the term "skip person" means--(1) a natural person assigned to a generation which is 2 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 such transfer may a distribution (including distributions on termination) be made from the trust to a non-skip person.

Section 26.2601-1(a)(1) of the Generation-Skipping Transfer Tax Regulations provides that except as otherwise provided in § 26.2601, the provisions of chapter 13 of the Internal Revenue Code of 1986 (Code) apply to any generation-skipping transfer

(as defined in § 2611) made after October 22, 1986.

Section 26.2601-1(b)(1)(i) 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 section 26.2601-1(b)(1)(ii)(B) (property includible in the gross estate under § 2038) or (C) (property includible in the gross estate under § 2042), any trust in existence on September 25, 1985, is considered an irrevocable trust.

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 by § 26.2601-1(b)(1), 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.

Section 26.2601-1(b)(4) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax under § 26.2601-1(b)(1), (b)(2), or (b)(3) will not cause the trust to lose its exempt status. The rules of § 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. They do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001 of the Code.

Section 26.2601-1(b)(4)(i)(B) provides that a court-approved settlement of a bona fide controversy regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to the provisions of chapter 13, if--(1) The settlement is the product of arm's length negotiations, and (2) The settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement.

Section 26.2601-1(b)(4)(i)(C) provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to be subject to the provisions of chapter 13, if--(1) The judicial action involves a bona fide issue, and (2) The construction is consistent with applicable state law that would be applied by the highest court of the state.

Section 26.2601-1(b)(4)(i)(D) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy § 26.2601-1(b)(4)(i)(A), (B), or (C) of this subsection)

by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, but only if--(1) The modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and (2) The modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

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 or gift tax.

A modification of a generation-skipping trust that is otherwise exempt under § 26.2601-1(b)(1)(i) will not result in a loss of its exempt or "grandfathered" status, if the trust meets the requirements of § 26.2601-1(b)(4).

We have examined the proposed Settlement Agreement in the context of relevant case law that applies to this case. The Settlement Agreement appears to provide an allocation of trust corpus that is within the range of reasonable settlements considering the issue presented. We have determined that the terms of the proposed Settlement Agreement fairly reflect the relative merits of the contentions of the respective parties to the dispute.

Accordingly, we conclude that, based on the facts presented and the terms of Trust, the division of Trust into five successor trusts and the implementation of the administrative changes to Trust pursuant to Court Order 2 approving Settlement Agreement will not cause the continuing trusts to lose their exempt status for generation-skipping transfer tax purposes as grandfathered trusts.

Ruling No. 2:

Section 61(a)(3) of the Code provides that gross income includes gains derived from dealings in property.

Section 1001(a) 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 §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 1001(b) provides that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property. Section 1001(c) provides that, except as otherwise provided in subtitle A, the entire amount of the gain or loss determined under §1001 on the sale or

exchange of property shall be recognized.

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 in kind or in extent, is treated as income or loss sustained. Properties are viewed as “different” in a sense that is “material” to the Code when their possessors enjoy legal entitlements, different in kind or extent from the properties given up. Cottage Savings Ass’n v. Commissioner, 499 U.S. 554, at 564-565 (1991).

The conversion, for the purpose of eliminating a survivorship feature, of a joint tenancy into a tenancy in common is a nontaxable transaction. Likewise, the severance of a joint tenancy under a partition action pursuant to state law is a nontaxable transaction. See Rev. Rul. 56-437, 1956-2 C.B. 507. Cf. Rev. Rul. 69-486, 1969-2 C. B. 159 (non-pro rata in-kind distribution from trust pursuant to agreement of beneficiaries is an exchange between the beneficiaries because the trustee was not authorized by the trust instrument or local law to make non-pro rata distribution).

As a general matter, a transaction will be a taxable event under § 1001 if (1) the transaction is a sale, exchange, or other disposition of property and (2) when there is an exchange, the exchange results in the receipt of property that is “materially different.” Under the agreement reached by the beneficiaries and trustees, Trust will be partitioned into five equal successor trusts with the trust assets divided on an in-kind pro-rata basis. A is the current beneficiary for life of Trust and will be the current beneficiary for life of the five successor trusts. The Settlement Agreement clarifies who will be remainder beneficiaries under Trust document after A’s death. The Settlement Agreement also settles disagreements under Trust about the amounts of discretionary distributions to A, about how trust assets are invested, and about the payments of trustees’ fees and attorneys’ fees from Trust assets.

The partition of Trust into five successor trusts as proposed will not be a sale, exchange, or other disposition of property except to the extent that Trust sells fractional shares of stock or odd lots of securities. Trust assets will be divided on an in-kind pro-rata basis, and the differences in the provisions for the successor trusts are all in settlement of a dispute among the parties about how Trust should be interpreted. That is, the establishment of, and the provisions for, the successor trusts provide for the distributions to beneficiaries as provided for in Trust subject to the settlement of the disputes about the interpretation of some of Trust’s provisions. Provisions for selection of trustees, for example, make sure that the beneficiaries’ interests as reflected in the Settlement Agreement will be protected. Consequently, the partition will not give rise to a realization of income under § 1001.

The division of Trust into five successor trusts and the implementation of the administrative changes to Trust pursuant to Court Order 2 approving the Settlement Agreement will not be a sale, exchange, or other disposition of property and, thus, will not result in gain or loss under §1001 of the Code. Fractional shares and odd lots of

securities sold by Trust are subject to gain or loss tax treatment under § 1001.

Ruling No. 3:

Section 2501(a)(1) provides the general rule for taxable transfers that a tax, computed as provided in § 2502, is hereby imposed for each calendar year on the transfer of property by gift during such calendar year by any individual, resident or nonresident.

Section 2511(a) provides that subject to the limitations contained in this chapter, the tax imposed by § 2501 will apply 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, but in the case of a nonresident not a citizen of the United States, will apply to a transfer only if the property is situated within the United States.

Section 2512(a) provides that if the gift is made in property, the value thereof at the date of the gift is considered the amount of the gift.

Section 2512(b) provides that where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeds the value of the consideration is deemed a gift, and is included in computing the amount of gifts made during the calendar year.

Based on the facts submitted and representations made, we conclude that the division of the Trust into five successor trusts and the implementation of the administrative changes to Trust pursuant to Court Order 2 approving the Settlement Agreement will not constitute a taxable transfer for gift tax purposes.

Except as ruled above, we express or imply no opinion concerning the federal tax consequences of this transaction under the cited provisions or any other provision of the Code.

This letter ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,
James C. Gibbons
Assistant to the Chief, Branch 7
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)