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Person To Contact: \_\_\_\_\_, ID No.

Telephone Number:

Refer Reply To:  
CC:PSI:04-PLR-121764-03  
Date: MARCH 22, 2004

Re:

Legend:

- Grantor =
- Spouse =
- Trust =
- Disinterested Trustee =
- Date 1 =
- Date 2 =
- Year 1 =
- \$w =
- \$x =
- \$y =
- Child A =
- Child B =
- Child C =
- Court =
  
- State =

Dear \_\_\_\_\_ :

This is in response to your September 26, 2003 letter, and prior correspondence, in which you requested rulings concerning the federal estate, generation-skipping transfer, and income tax consequences of the proposed division of three trusts.

## Facts

The facts and representations submitted are summarized as follows: On Date 1, prior to September 25, 1985, Grantor established an inter vivos, irrevocable trust, Trust, and transferred to Trust cash in the amount of \$w, bonds valued at \$x, and non-voting common stock valued at \$y. In Year 1, the total value of the transfer was reported by Grantor on a timely filed gift tax return on which Grantor and Spouse elected to split the gift for federal gift tax purposes. No additions or contributions have been made to Trust after Date 1. At the time Trust was established, Grantor had three living children, Child A, Child B, and Child C, and no other issue.

Article II of Trust provides that the trustees are to allocate all property of Trust by right of representation among Grantor's issue living at the time such property is received by the trustees. Pursuant to Article II, the trustees held the trust property in three separate trusts, Child A Trust, Child B Trust, and Child C Trust, one for each of the Grantor's children. Each child's trust so allocated is to be held and disposed of by the trustees upon the terms set forth in Article III.

Article IIIA. provides that net income and principal of each child's trust is to be paid to Grantor's child or child's issue, as the Disinterested Trustee deems desirable for the health, education, maintenance and support of any one or more of such persons. The Disinterested Trustee may also pay net income and principal to any other descendant of Grantor for health, education, maintenance or support, although the needs of Grantor's child and child's issue should be given primary consideration.

Article IIIB. provides that during Grantor's lifetime, whenever a gift is made to a child's trust, the child of Grantor and each of the child's then living issue shall have the right to make a withdrawal from the principal of that child's trust. The amount which may be withdrawn by the child shall be the lesser of the amount of the gift and twice the maximum amount then permitted as an annual exclusion from taxable gifts to a single donee under section 2503(b) of the Internal Revenue Code. The amount which may be withdrawn by each of the issue of such child shall be the lesser of (a) the amount of the gift reduced by the amount which may be withdrawn by the child and (b) twice the maximum amount then permitted as an annual exclusion from taxable gifts to a single donee under section 2503(b). Such right shall be exercisable in writing by the holder of the right to withdraw within 30 days after the date of the gift, but not later than the end of the calendar year in which such gift is made.

Article IIIC. provides that upon the death of a child of Grantor, the trustees are to pay the remaining principal of the child's trust, together with any then undistributed income, in accordance with the exercise by such child of a special power of appointment. To the extent such child shall fail to exercise this power of appointment, the principal and income is to be paid to the child's then living issue, by right of

representation or, in default of such issue, to Grantor's then living issue, by right of representation.

Article VA. provides that a special power of appointment is one exercisable to or for the benefit of Grantor's issue living at the death of the holder of the power or thereafter born, in such proportions, as the holder of the power shall appoint by will.

Article VB. provides that each trust shall terminate in all events 21 years after the death of the survivor of all of Grantor's issue living on the date of Trust.

Article XII defines the term "the Disinterested Trustee" to mean all trustees who are not eligible, and who are not legally obligated to support any person who is eligible, to receive current distributions of income or principal from any trust created under Trust.

Each child allowed his/her power of withdrawal granted under Article IIIB to lapse in Year 1.

The trustees petitioned Court seeking its approval to divide Child A Trust, Child B Trust, and Child C Trust into separate trusts. Pursuant to the proposed severance, Child A1 Trust, Child B1 Trust, and Child C1 Trust will hold the assets from Child A Trust, Child B Trust, and Child C Trust attributable to the first \$5,000 of the original contribution to each such trust over which Child A, Child B, and Child C allowed his/her respective withdrawal power to lapse. Further, pursuant to the proposed severance, Child A2 Trust, Child B2 Trust, and Child C2 Trust will hold the assets from Child A Trust, Child B Trust, and Child C Trust attributable to that portion of the original contribution to each such trust in excess of \$5,000 over which Child A, Child B, and Child C allowed his/her respective withdrawal power to lapse. The division will be on a fractional basis, with each trust receiving an appropriate fraction of each asset held by the trust.

On Date 2, Court ordered that the trustees of Trust, upon receipt of favorable rulings from the Internal Revenue Service, are authorized to sever each of the three child's trusts, allocating each asset on a fractional share basis, into two separate trusts.

The trustees request the following rulings:

1. After the severance of Child A Trust, Child B Trust, and Child C Trust, (i) none of the post-severance trusts will be includable in the gross estate of the Grantor or Spouse for federal estate tax purposes; (ii) the assets of Child A1 Trust, Child B1 Trust, and Child C1 Trust will not be includable in the particular child's gross estate for federal estate tax purposes, and (iii) the assets of Child A2 Trust, Child B2 Trust, and Child C2 Trust will be includable in the particular child's gross estate for federal estate tax purposes under sections 2041(a)(2) and (b)(2).

2. The proposed severance of each child's trust will not affect the GST exempt status of Child A Trust, Child B Trust, Child C Trust, Child A1 Trust, Child B1 Trust, Child C1 Trust, Child A2 Trust, Child B2 Trust, or Child C2 Trust.

3. The proposed severance of each child's trust will not be treated as a taxable event for federal income tax purposes.

### Ruling Request 1

Section 2001(a) imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

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 the decedent's death.

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 or she has retained for life or for any period not ascertainable without reference to his/her death or for any period which does not in fact end before his or her 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 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, if the possession or enjoyment thereof can, through ownership of such interest be obtained only by surviving the decedent, and the decedent has retained a reversionary interest in the 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.

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 which is of such a nature that if it were a transfer of property owned by the decedent, such property would be includable in the decedent's gross estate under section 2035 through 2038, inclusive.

Section 2041(b)(1) defines the term "general power of appointment" as a power that is exercisable in favor of the decedent, the decedent's estate, the decedent's creditors, or the creditors of the decedent's estate.

Section 2041(b)(2) provides that the lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of the power to the extent that the property that could have been appointed by exercise of the lapsed power during the calendar year exceeds the greater of \$5,000 or 5 percent of the aggregate value, at the time of such lapse, of the assets out of which the exercise of the lapsed powers could be satisfied.

In the present case, neither Grantor nor Spouse retained any interests in Child A Trust, Child B Trust, or Child C Trust for purposes of sections 2036, 2037, 2038, or 2041. Accordingly, the assets of the post-severance trusts will not be includible in Grantor's or Spouse's gross estate for federal estate tax purposes.

Each child allowed his/her power of withdrawal granted under Article IIIB of Trust to lapse in Year 1. Pursuant to the proposed severance of each child's trust, Child A1 Trust, Child B1 Trust, and Child C1 Trust will hold the assets from Child A Trust, Child B Trust, and Child C Trust attributable to the first \$5,000 of the original contribution to each such trust over which Child A, Child B, and Child C allowed his/her respective withdrawal power to lapse. The lapse of this withdrawal power was not a release of a general power of appointment under section 2041(b)(2). In addition, each child has a special power of appointment to appoint the principal of his/her respective trust upon his/her death under Article VA of Trust to or for the benefit of Grantor's issue living at the death of the powerholder, or thereafter born. Each child's special power of appointment is not a general power of appointment as defined in section 2041(b)(1). Accordingly, the assets of Child A1 Trust, Child B1 Trust, and Child C1 Trust will not be includible in the particular child's gross estate for federal estate tax purposes.

Pursuant to the proposed severance of each child's trust, Child A2 Trust, Child B2 Trust, and Child C2 Trust will hold the assets from Child A Trust, Child B Trust, and Child C Trust attributable to that portion of the original contribution to each such trust in excess of \$5,000 over which Child A, Child B, and Child C allowed his/her respective withdrawal power to lapse. Under section 2041(b)(2), such lapse is treated as a release of a general power of appointment for purposes of section 2041(a)(2), and accordingly,

the assets of Child A2 Trust, Child B2 Trust, and Child C2 Trust will be includible in the particular child's gross estate for federal estate tax purposes.

### Ruling Request 2

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

Under section 1433(a) of the Tax Reform Act of 1986 (Act) and § 26.2601-1(a) of the Generation-Skipping Transfer Tax Regulations, the generation-skipping transfer tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under section 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i), the tax does not apply to a 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)(4)(i) 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 will not cause the trust to lose its exempt status. The regulation provides that the rules contained in the paragraph are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. The rules 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 section 1001.

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 paragraph (b)(4)(1)(A), (B), or (C) of this section) 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 the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and 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.

It is represented that no additions (actual or constructive) have been made to Trust, Child A Trust, Child B Trust, or Child C Trust after September 25, 1985.

The proposed severance of Child A Trust, Child B Trust, and Child C Trust will not result in a shift of any beneficial interest in such trusts to any beneficiary who occupies a generation lower than the persons holding the beneficial interests. Further, the proposed severance will not extend the time for vesting of any beneficial interest in

the new trusts beyond the period provided for in the trusts. Accordingly, the proposed severance of Child A Trust, Child B Trust, and Child C Trust will not affect the GST exempt status of those trusts or the resulting trusts, Child A1 Trust, Child B1 Trust, Child C1 Trust, Child A2 Trust, Child B2 Trust, or Child C2 Trust, for purposes of chapter 13.

### Ruling Request 3

Section 61 provides that gross income means all income from whatever source derived. 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 section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

Section 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 received.

Section 1001(c) provides that, except as otherwise provided in subtitle A, the entire amount of the gain or loss, determined under section 1001, on the sale or exchange of property shall be recognized.

Section 1.1001-1(a) of the Income Tax Regulations provides that 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 as loss sustained.

An exchange of property results in the realization of gain or loss under section 1001 if the properties exchanged are materially different. Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991). Properties exchanged are materially different if the properties embody legal entitlements "different in kind or extent" or if the properties confer "different rights and powers." Id. at 565. In Cottage Savings, 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 interests in the loans. Id. at 566. In defining what constitutes a "material difference" for purposes of section 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. Id. at 564-65.

In analyzing the instant trust division, for section 1001 to apply there must be a sale or disposition of an interest in property and the property interests exchanged must be materially different.

A trust division, unless prescribed by the original trust or local law, is a deemed sale or disposition of an interest in property. In this context, a deemed sale or disposition of an interest of property is an exchange of materially different interests in property subject to section 1001 if either (1) the original trust assets are allocated to the post-severance trusts in a non-pro rata manner or (2) the post-severance trusts contain new or additional terms and conditions.

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 section 1001.

The present case is distinguishable from Rev. Rul. 69-486 because all of the assets from Child A Trust, Child B Trust, and Child C Trust will be divided and allocated pro rata between the post-severance trusts. Accordingly, the proposed transaction will not be treated as a pro rata distribution followed by an exchange of assets among the beneficiaries of the child's trusts.

A trust division may also result in the exchange of materially different interests in property if a post-severance trust contains new or additional terms and conditions. Rev. Rul. 56-437, 1956-2 C.B. 507, provides that a partition of jointly owned property is not a sale or other disposition of property where the co-owners of the joint property sever the joint interests, but do not acquire a new or additional interest as a result thereof. The transaction here is similar to the kinds of transactions discussed in Rev. Rul. 56-437, since the trusts here are to be divided, but all other provisions of the trusts will remain unchanged. Thus, the proposed transaction will not result in a material difference in the kind or extent of the legal entitlements enjoyed by the beneficiaries.

Accordingly, it is also consistent with the Supreme Court's opinion in Cottage Savings to find that the interests of the beneficiaries in the post-severance trusts, will not differ materially from their interests in the original trusts. The proposed division will not change the interests of the beneficiaries. Instead, the beneficiaries will be entitled to the same benefits after the proposed transaction as before. Therefore, the proposed severance of each child's trust will not constitute a taxable disposition under section 1001.



A copy of this letter should be attached to any income, estate, or generation-skipping transfer tax returns that you may file relating to these matters.

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

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for the ruling, it is subject to verification on examination.

Except as specifically ruled herein, we express no opinion on the federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code.

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

Sincerely,

Lorraine E. Gardner  
Senior Counsel, Branch 4  
Office of Chief Counsel  
(Passthroughs and Special  
Industries)

Enclosures

Copy for section 6110 purposes

cc: