

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200438012**

Release Date: 9/17/04

Index Number: 2601.04-01, 2501.00-00,
61.14-00, 1001.00-00,
2601.00-00

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:04 – PLR-113028-03

Date: MAY 17, 2004

Re:

LEGEND

Decedent =
W =
Trust =

Corporate Trustee =

Bank =
Date 1 =
Date 2 =
Date 3 =
Child 1 =
Child 2 =
Child 3 =
Child 4 =
State Court =

State Statute =

Dear :

This is in response to the February 13, 2003, letter submitted by your authorized representative on your behalf, and subsequent correspondence, concerning the generation-skipping transfer (GST) tax and income tax consequences of the proposed division of Trust.

PLR-113028-03

The facts and representations submitted are summarized as follows. On Date 1, Decedent established Trust, a revocable trust, that became irrevocable upon Decedent's death on Date 2, prior to September 25, 1985.

Upon Decedent's death, the Trust corpus was divided into two shares: a marital share for the benefit of W, to be administered pursuant to Article VII; and a residuary share for the benefit of Decedent's descendants, to be administered pursuant to Article VIII.

In accordance with Article VII, the Trust corpus allocated to the marital share was distributed pursuant to W's exercise of a general power of appointment, and that corpus never became a part of the residuary share. Thus, the portion of Trust corpus allocated to the residuary share now constitutes the entire corpus of Trust. The current co-trustees of Trust are Corporate Trustee (a trust company) and Decedent's son, Child 1.

Article VIII, Section 1, of Trust provides that the trustee shall hold, care for, manage, control, invest and reinvest the trust residuary share, and shall pay to or apply for the benefit of Decedent's four children, Child 1, Child 2, Child 3, and Child 4, the entire net income of the trust in substantially equal shares at least annually, during their lifetimes.

Article VIII, Section 2, of Trust provides that, upon the death of a child, that child's share of the net income shall be paid to or applied for the benefit of that child's then living issue by right of representation. If, however, a deceased child leaves no issue then living, the share shall be applied for the benefit of Decedent's then living issue by right of representation. Child 4 is deceased and left no issue. Therefore, Decedent's three remaining living children are the only beneficiaries entitled to current income distributions from Trust.

Article VIII, Section 3, of Trust provides that Trust is to terminate upon the death of the last surviving grandchild who was living at the time of Decedent's death. On termination, the Trust corpus is to be distributed to the then current income beneficiaries in proportion to their income interest. If a beneficiary is a minor, the trustees are authorized to withhold that beneficiary's share in trust.

Article VIII, Section 5, of Trust provides that Corporate Trustee may distribute principal to trust beneficiaries out of the overall trust assets if the net income payable to a beneficiary, together with income from other sources, is insufficient to assure the beneficiary's maintenance, support, education, advancement or general welfare or the beneficiary suffers illness, distress or other hardship. These distributions may be made to one beneficiary at the exclusion of another and may be made in unequal amounts.

Under State Statute, a trustee has the power to "divide trust property into 2 or more separate portions or trusts with substantially identical terms and conditions and to

PLR-113028-03

allocate property between them, in order to simplify administration for generation skipping transfer tax purposes, to segregate property for management purposes, or to meet another trust objective.”

On Date 3, Child 1, as the co-trustee of Trust, petitioned State Court to remove Corporate Trustee and to name Bank, an institution of which he is the Chairman of the Board, as corporate trustee. This petition is currently pending in State Court. Corporate Trustee also petitioned State Court to establish an investment dispute resolution mechanism if Corporate Trustee is to remain as co-trustee. There has been a history of differing opinions between Child 1 and Corporate Trustee as to the permissible investments under Trust and investment decisions that pertain to assets of Trust. Previous litigation and pending litigation concerning Trust has resulted in a considerable expenditure of Trust assets.

Accordingly, several beneficiaries have petitioned State Court to divide Trust into three separate trusts. If the petition is granted, Trust would be divided on a fractional basis into three separate trusts, Trust 1, Trust 2, and Trust 3, for each living child of Decedent and that child's issue. Each of Trusts 1-3 would receive exactly one-third of every asset held by Trust at the time of the severance. The terms of Trusts 1-3 would be as follows:

1. Each child would serve as the initial individual trustee of his or her separate trust. If an individual trustee became unable or unwilling to serve, a majority of the adult issue of the child for whom the separate trust was created would select a successor individual trustee.
2. Each child would appoint the initial corporate trustee of his or her separate trust. The child, or if the child was not living, a majority of the adult income beneficiaries of the separate trust, could remove the corporate trustee, in which event a court with jurisdiction would appoint a successor corporate trustee.
3. Each child would be entitled to receive the entire net income from his or her separate trust during such child's lifetime.
4. Upon the death of a child, the entire net income of such child's trust would be paid to such child's then living issue by right of representation. If a child were to die with no issue then living, the child's separate trust would be divided and distributed in equal shares to the other of Trusts 1-3 then in existence.
5. If, in the opinion of the corporate trustee, the net income payable to any of the beneficiaries of a separate trust designated for a child or such child's issue, together with the beneficiary's other income and assets, was not sufficient to assure the beneficiary's maintenance, support, education, advancement or general welfare, or in

PLR-113028-03

the event of illness, distress, or other hardship, the corporate trustee could distribute principal of the separate trust to any one or more of the beneficiaries of such separate trust to accomplish such purposes.

6. The corporate trustee of a separate trust would have the right to make principal distributions, excluding any or all of the beneficiaries of a separate trust from participation in principal distributions during the continuance of such separate trust, and to make unequal distributions among the beneficiaries of such separate trust.

7. Upon the death of the last continuing survivor of the grandchildren of Decedent who are children of the child for whom a separate trust is created and who were living at the time of Decedent's death, such separate trust would terminate, and the property of such separate trust would be distributed to the beneficiaries then entitled to receive the income from such separate trust in the same proportions as they were entitled to receive such income.

Trust was irrevocable on September 25, 1985. It is represented that no actual or constructive additions have been made to Trust after that date.

You have requested the following ruling requests:

- (1) The severance of Trust or the formation and funding of Trusts 1-3 will not result in any generation skipping-transfers (either at the time of severance or thereafter) and that the grandfathered, exempt status of Trust under section 26.2601-1(b)(1)(i) will be equally applicable to Trusts 1-3;
- (2) The severance of Trust will not result in taxable gifts by any person under section 2501; and,
- (3) The severance of Trust or the formation and funding of Trusts 1-3 will not be considered to be a sale or other disposition of trust property, will not cause Trust, any of Trusts 1-3, or any of the beneficiaries thereof to realize any taxable income, gains, or losses under sections 61 or 1001, and that under sections 643(e)(1) and 1223(2), the basis and holding period of the assets of Trust will continue to apply to these assets after their transfer to Trusts 1-3.

Issue 1

Section 2601 imposes a tax on each generation-skipping transfer made by a transferor to a skip person.

Under section 1433(a) of the Tax Reform Act of 1986, the generation-skipping transfer tax is generally applicable to generation-skipping transfers made after October

PLR-113028-03

22, 1986. However, under section 1433(b)(2)(A) of the Tax Reform Act and section 26.2601-1(b)(1)(i) of the regulations, the tax does not apply to a transfer from a trust, if the trust was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date.

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.

Section 26.2601-1(b)(4)(i)(D) provides that a modification will not cause an exempt trust to be subject to the provisions of chapter 13, 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. A modification that does not result in an increase in the amount of a GST transfer or the creation of a new GST transfer will not cause the trust to lose its exempt status.

Section 26.2601-1(b)(4)(i)(E), Example 5, involves a trust that is irrevocable on or before September 25, 1985. The trustee has the discretion to distribute income and principal to A, B, and their issue in such amounts as the trustee deems appropriate. On the death of the last to die of A and B, the trust principal is to be distributed to the living issue of A and B, per stirpes. In 2002, the appropriate local court approved the division of the trust into two equal trusts, one for the benefit of A and A's issue and one for the benefit of B and B's issue. The trust for A and A's issue provides that the trustee has the discretion to distribute trust income and corpus to A and A's issue in such amounts as the trustee deems appropriate. On A's death, the trust is to be terminated and the corpus distributed to A's issue per stirpes. The terms of the trust for B and B's issue are identical except for the beneficiaries. The example concludes that the division of the trust into two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the division. In addition, the division does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the two partitioned trusts resulting from the division will not be subject to the provisions of chapter 13.

In this case, Trust was irrevocable on September 25, 1985. It is represented that no additions have been made to Trust after that date. The proposed division of Trust will result in three trusts, one for each child. The proposed division of Trust and pro rata allocation of assets among the three equal trusts will not shift a beneficial interest to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the division. Further, the division will not extend the time for vesting of

PLR-113028-03

any beneficial interest beyond the period provided for in the original trust. Accordingly, based on the facts submitted and the representations made, we conclude that neither the severance of Trust into three trusts one trust for the benefit of Child 1 and Child 1's issue (Trust 1), one trust for the benefit of Child 2 and Child 2's issue (Trust 2), and one trust for the benefit of Child 3 and Child 3's issue (Trust 3), nor the formation and funding of Trusts 1-3 will result in any generation skipping transfers (either at the time of severance or thereafter) and that the grandfathered, exempt status of Trust under section 26.2601-1(b)(1)(i) will be equally applicable to the Trusts 1-3.

This ruling is conditioned on the following: (1) any corporate trustee of Trusts 1-3 will not be a party that is related or subordinate as defined in section 672(c) to any beneficiary of Trusts 1, 2, or 3, respectively; and (2) Bank will not be the corporate trustee of Trusts 1-3.

Issue 2

Section 2501(a) imposes a tax on the transfer of property by gift by an individual, resident or nonresident.

Section 2511(a) provides that the tax imposed by section 2501 applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect and whether the property is real or personal, tangible or intangible.

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

In this case, upon the division of Trust into Trusts 1-3, each beneficiary of Trusts 1-3 will have the same beneficial interest as he or she had under Trust. Because the beneficial interests of the beneficiaries 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 division. Accordingly, we conclude that the proposed division of Trust and the pro rata allocation of the assets of Trust among Trusts 1-3 will not result in a transfer subject to gift tax under section 2501 by any of the beneficiaries.

Issue 3

Section 61(a)(3) provides that gross income includes gains derived from dealings in property and, under section 61(a)(15), from an interest in a trust.

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 section 1011 over the amount realized.

PLR-113028-03

Section 1001(b) states 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 (other than money) received. Under section 1001(c), 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 in either 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 if the co-owners of the joint property sever their joint interests but do not acquire a new or additional interest as a result of the transaction. Thus, neither gain nor loss is realized on a partition. See Rev. Rul. 56-437, 1956-2 C.B. 507 (1991).

Cottage Savings Association 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 section 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 mortgages were considered "substantially identical" by the agency that regulated the financial institution.

The Supreme Court of the United States in Cottage Savings, 499 U.S. at 560-61, concluded that section 1.1001-1 reasonably interprets section 1001(a) and stated that an exchange of property gives rise to a realization event under section 1001(a) if the properties exchanged are "materially different." 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 more different in kind or extent. Cottage Savings, 499 U.S. at 564-65. 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. Cottage Savings, 499 U.S. at 566

It is consistent with the Supreme Court's opinion in Cottage Savings to conclude that the interests of the beneficiaries of the Trusts 1-3 will not differ materially from their interests in Trust. In the proposed transaction, the Trust assets will be partitioned in accordance with State Statute on a pro rata basis. Except for the changes described above, all other provisions of Trust will remain unchanged. Accordingly, the proposed transaction will not result in a material difference in kind or extent of the legal entitlements enjoyed by the beneficiaries, and no gain or loss is realized or

PLR-113028-03

recognized by Trust, Trusts 1-3 or by any beneficiaries thereof, on the partition of the trust for purposes of sections 61 and 1001(a). In addition, the basis and holding period of the assets of Trust will continue to apply to these assets after their transfer to Trusts 1-3 pursuant to sections 643(e)(1) and 1223(2).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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 rulings, it is subject to verification on examination

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

Sincerely,

George L. Masnik
Chief, Branch 4
(Passthroughs and Special Industries)

Enclosures

Copy for section 6110 purposes
Copy of this letter