

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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Person To Contact:

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Date:

August 09, 2004

**LEGEND**

Husband =

Wife =

Irrevocable Trust =

Date 1 =

Daughter =

Grandchild 1 =

Grandchild 2 =

Grandchild 3 =

Date 2 =

State A =

\$x =

Date 3 =

Date 4 =

Probate Court =

Bank =

Date 5            =

Date 6            =

Dear             :

In a letter dated December 1, 2003, you requested rulings regarding the generation-skipping transfer (GST) tax and income tax consequences of a judicial modification to an irrevocable trust. This letter responds to your request.

The facts and representations are as follows: Husband and Wife created Irrevocable Trust on Date 1, a date prior to September 25, 1985, for the initial benefit of themselves and subsequently for the benefit of Daughter and Daughter's descendants.

Section 6 of Irrevocable Trust provides, in part, that upon the death of the first to die of Husband and Wife, the trustees shall set aside a separate trust (Trust A) for the sole benefit of the survivor. Trust A shall consist of (i) an amount equal to one-half of any community property of Husband and Wife transferred to the trustees during the joint lifetimes of Husband and Wife, representing the community interest of the survivor in such property; (ii) an amount equal to one-half of all proceeds of insurance upon the life of the first to die of Husband and Wife and one-half of other death proceeds which mature at the death of the first to die of Husband and Wife; (iii) any separate property of the survivor of Husband and Wife held by the trustees; and (iv) any property added to Trust A by the survivor of Husband and Wife.

Section 7, paragraph (a) provides generally that the balance of the trust estate that does not become part of Trust A upon the death of the survivor of Husband and Wife, shall be set aside as a separate trust (Trust B). The trustees of Trust B shall pay to or apply for the benefit of the survivor of Husband and Wife the income of Trust B in quarterly or other convenient installments. In addition, the trustees shall pay to or apply for the benefit of the survivor of Husband and Wife so much of the principal of Trust B as the trustees deem necessary or desirable for the health, education, support, and maintenance of the survivor of Husband and Wife. Upon the death of the survivor of Husband and Wife, the trustees shall hold the remaining principal of Trust B in accordance with Section 7, paragraph (c), provided, however, that upon the death of the survivor of Husband and Wife, the trustees shall pay from the principal of Trust B to the executor of the survivor's estate the difference between all taxes that must be paid by reason of the survivor's death and those taxes that would be payable by reason of the survivor's death had the trust principal not been included in the survivor's estate for the purpose of calculating such taxes.

Section 7, paragraph (c) provides that upon the death of the survivor of Husband and Wife and after the satisfaction of certain specific bequests, the remainder of Trust B is to be divided as follows: four-sixteenths (4/16) is to be distributed outright to Daughter, nine-sixteenths (9/16) is to be divided into three separate trusts for the benefit of Grandchild 1, Grandchild 2, and Grandchild 3 (each a "Grandchild's Trust" or collectively the "Grandchildren's Trusts"), and three-sixteenths (3/16) is to be allocated

to one trust for the benefit of the then living issue of Grandchild 1, Grandchild 2, and Grandchild 3 (the "Grandchildren's Issue Trust").

Section 7, paragraph (d) provides generally that the corporate trustee may make discretionary distributions of income and principal from each Grandchild's Trust and from the Grandchildren's Issue Trust for the health, support, maintenance, and education of the respective beneficiaries of those trusts.

Husband died testate on Date 2 a resident of State A. Husband was survived by Wife, Daughter, Grandchild 1, Grandchild 2, Grandchild 3, and descendants of Grandchild 1, Grandchild 2, and Grandchild 3. Following Husband's death, the trustees funded Trust B with stock valued at \$x.

Wife died testate on Date 3 a resident of State A. Wife was survived by Daughter, Grandchild 1, Grandchild 2, Grandchild 3, and descendants of Grandchild 1, Grandchild 2, and Grandchild 3.

On Date 4, the trustees of Irrevocable Trust petitioned Probate Court for a declaratory judgment permitting certain modifications to Irrevocable Trust. The proposed modifications provide generally as follows:

Each of the three Grandchildren's Trusts would be modified to provide for each grandchild to be the sole trustee of his or her respective trust. All provisions for a corporate co-trustee would be deleted. If a grandchild resigns or is otherwise unable to serve as trustee of his or her respective trust, the grandchild's spouse shall serve as successor trustee of the trust established for the deceased grandchild. If the grandchild's spouse is also unable to serve, the grandchild's then living siblings shall serve as successor trustee.

The Grandchildren's Issue Trust would be modified to provide for Grandchild 1, Grandchild 2, and Grandchild 3, or the survivor(s) of them, to serve as co-trustees of the trust. In the event of the death, resignation, incapacity, or other inability of a grandchild to serve as trustee, the then living spouse of such grandchild shall become a trustee in place of the deceased grandchild. In the event of the death, resignation, incapacity, or other inability to serve of all of the individual trustees of the Grandchildren's Issue Trust, a majority of the current beneficiaries of the trust will have the power to appoint a successor corporate trustee, or may petition Probate Court to request the appointment of either a corporate or individual successor trustee.

As part of the judicial proceedings, Bank will resign as a co-trustee of the Grandchildren's Trusts and the Grandchildren's Issue Trust. All references in the trust agreement to a corporate trustee would be deleted and all powers of the trustee would become vested in the acting trustees of each trust.

The trustee would be required to provide at least a semi-annual accounting to the current income and adult successor income beneficiaries of the trust.

On Date 5, Probate Court entered a declaratory judgment and order for relief that approved the proposed modifications to the trust. On Date 6, Probate Court entered a Final Judgment Nunc Pro Tunc that made clerical corrections to the Date 5 order.

It has been represented that no additions have been made to Trust B subsequent to September 25, 1985. In addition, it has been represented that in dividing Trust B into the Grandchildren's Trusts and the Grandchildren's Issue Trust pursuant to the terms of the trust agreement, each existing asset of the trust will be divided pro rata among the four trusts in accordance with the fractional interest of each.

You have requested the following rulings:

1. The judicial modification of the trust agreement will not result in a loss of exempt status for GST tax purposes of Trust B or any of the trusts created from the division of Trust B into the Grandchildren's Trusts and the Grandchildren's Issue Trust pursuant to the terms of the trust agreement.
2. Neither Trust B, nor any of the trusts created from the division of Trust B into the Grandchildren's Trusts and the Grandchildren's Issue Trust, nor any beneficiary, will realize gain or loss under § 1001 of the Internal Revenue Code as a result of the division of Trust B into separate trusts pursuant to the trust agreement or as a result of the judicial modification of the trust agreement.

### Ruling 1

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

Section 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 provide that the generation-skipping transfer tax shall not apply to any generation-skipping transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added).

Section 26.2601-1(b)(1)(ii)(A) provides that any trust in existence on September 25, 1985, will be considered an irrevocable trust except as provided in § 26.2601-1(b)(1)(ii) (B) or (C) (relating to property includible in the grantor's gross estate under §§ 2038 and 2042).

Section 26.2601-1(b)(1)(iv) provides that if an addition is made after September 25, 1985, to an irrevocable trust, which is excluded from the application of chapter 13 by § 1433(b)(2)(A) of the 1986 Act, a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the provisions of chapter 13.

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), (2), or (3) (hereinafter referred to as an exempt trust) will not cause the trust to lose its exempt status. In general, unless specifically provided otherwise, the rules contained in § 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. Unless specifically noted, 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 § 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 paragraphs (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.

In this case, Trust B is considered irrevocable because neither § 2038 nor § 2042 apply. Also, it is represented that no additions were made to Trust B after September 25, 1985. Consequently, Trust B is currently exempt from the GST tax.

The proposed modifications to Trust B will not shift any beneficial interest in Trust B, or any of the individual trusts thereunder, to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification. In addition, the proposed transactions will not extend the time for vesting of any beneficial interest in the trusts beyond the period provided for in the original trusts. Further, the modifications will not result in an actual or constructive addition to any of the trusts.

Thus, the judicial modification of the trust agreement will not result in a loss of exempt status from the GST tax for Trust B or any of the trusts created from the division of Trust B into the Grandchildren's Trusts and the Grandchildren's Issue Trust pursuant to the terms of the trust agreement.

## Ruling 2

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

Section 1001(a) provides for the computation of gain or loss from the sale or other disposition of property. Section 1.1001-1 of the Income Tax Regulations states

that except as otherwise provided in subtitle A, 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.

In Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), the Supreme Court considered whether an exchange of property was a taxable event under § 1001. In that case, the Court held that the exchange was taxable under § 1001, as the participation interests that were exchanged derived from loans to different obligors and the loans were secured by different homes. The Court reasoned that an exchange of property is a taxable event under § 1001 and § 1.1001-1(a) if the properties embody legally distinct entitlements. Id. at 566.

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

In this case, neither the proposed modification of the trust instrument regarding successor trustees nor the proposed pro rata partition of Trust B will materially change the interest of any beneficiary. Based on the information submitted and the representations made in the ruling request, neither the proposed judicial modification of the trust agreement nor the proposed partition of Trust B will result in the realization of gain or loss under § 1001 by Trust B, its successor trusts, or any beneficiary.

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) provides that it may not be used or cited as precedent.

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

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.

Sincerely,

Melissa C. Liquerman  
Branch Chief, Branch 9  
Office of Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosure

Copy for 6110 purposes