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Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B09 – PLR-150570-03

Date:
September 30, 2004

Legend:

Trust =

Decedent =

Date 1 =

Spouse =

Child =

Grandchild 1 =

Grandchild 2 =

Grandchild 3 =

Date 2 =

Great-Grandchild 1 =

Great-Grandchild 2 =

Great-Grandchild 3 =

Great-Grandchild 4 =

Great-Grandchild 5 =

Great-Grandchild 6 =

Date 3 =

Date 4 =

State =

Date 5 =

State Statute 1 =

State Statute 2 =

Date 6 =

Dear _____ :

This is in response to your letter dated August 27, 2004, and prior correspondence, requesting rulings on the income and generation-skipping transfer (GST) tax consequences of a division and modification of the Trust.

The facts and representations submitted are summarized as follows: Decedent established the Trust on Date 1 for the benefit of Spouse, Child, Decedent's grandchildren, and their lawful issue.

Paragraph 1 of the Trust provides that the trustee shall from time to time at convenient intervals pay to Spouse for and during her life, the net income of the trust.

Paragraph 2 of the Trust provides that upon the death of Spouse, the trustees shall divide the trust into two equal shares. The trustees shall, in their discretion, expend and disburse the net income from the first share for the benefit of Child for and during his life. The trustees may, in their sole discretion, disburse the whole or any portion of the net income from the first share as shall not have been expended for the benefit of Child, for the benefit of Decedent's grandchildren, Grandchild 1, Grandchild 2, and Grandchild 3.

Paragraph 3(a) of the Trust provides that after the death of Child, the net income from the first share of the trust shall be paid to Grandchild 1, Grandchild 2, and Grandchild 3 and to their lawful issue, share and share alike, per stirpes.

Paragraph 3(b) of the Trust provides that the trustees, in their discretion, shall expend and disburse the net income from the second share of the trust for the benefit of Grandchild 1, Grandchild 2, and Grandchild 3 until the youngest of them shall have attained the age of twenty-five. After the youngest of Decedent's grandchildren attains the age of twenty-five, the net income from the second share of the trust shall be paid to Grandchild 1, Grandchild 2, and Grandchild 3 and their lawful issue then surviving, share and share alike, per stirpes.

Paragraph 4 of the Trust provides that in case the net income payable to any beneficiary is at any time in the opinion of the trustees insufficient for the maintenance and education of such beneficiary, the trustees may in their discretion expend from time to time such sum or sums from the principal of the trust as may be necessary for that purpose.

Paragraph 5 of the Trust provides that the trust shall terminate twenty years after the death of the survivor of Spouse, Child, and Decedent's grandchildren: Grandchild 1,

Grandchild 2, and Grandchild 3. Upon termination, the trustees shall transfer, pay over, deliver and convey the trust estate, together with all accumulations and undistributed income to the lawful issue of Decedent's grandchildren, share and share alike, per stirpes.

Decedent died on Date 2. Grandchild 1, Grandchild 2, and Grandchild 3 are all deceased. Grandchild 1 was survived by two children: Great-Grandchild 1 and Great-Grandchild 2. Grandchild 2 was survived by four children: Great-Grandchild 3, Great-Grandchild 4, Great-Grandchild 5, and Great-Grandchild 6. Grandchild 3 was not survived by lawful issue. Great-Grandchildren 1 through 6 are collectively referred to as the "Primary Beneficiaries."

Grandchild 2 died on Date 3, and survived each of Spouse, Child, Grandchild 1, and Grandchild 3. Accordingly, the Trust will terminate on Date 4 (twenty years after the date of Grandchild 2's death), and the trust estate will be distributed to the Primary Beneficiaries, share and share alike, per stirpes, if they are then living.

The Trust is governed by State law. It is represented that no additions or constructive additions have been made to the Trust after September 25, 1985.

The trustees represent that the investment goals and needs of the Primary Beneficiaries of the Trust have become divergent. Accordingly, on Date 5, the trustees and the Primary Beneficiaries of the Trust entered into an agreement as authorized by State law. The agreement divided the Trust into three separate and equivalent sub-trusts pursuant to the trust severance provisions of State Statute 1 and converted each of the sub-trusts from an income trust to a total return trust as authorized under the total return trust provisions of State Statute 2.

As a result of the severance of the Trust, each and every asset of the Trust was severed on a fractional basis and allocated proportionately among three sub-trusts. The first sub-trust is for the primary benefit of Great-Grandchild 1. The second sub-trust is for the primary benefit of Great-Grandchild 2. The third sub-trust is for the primary benefit of Great-Grandchildren 3 through 6.

State law authorizes trustees, without court approval, to sever a single trust into two or more separate trusts provided that the aggregate interest of each beneficiary of the separate sub-trusts after severance is substantially equivalent to the beneficiary's interest before the severance. The trustees allocated a fractional share of the assets of the Trust to the sub-trusts. After the severance, each Primary Beneficiary has an interest identical to their interest in the income and principal of the sub-trust that he or she had in the Trust prior to the severance. In addition, each sub-trust has terms identical to those of the Trust. Each sub-trust will terminate on Date 4, and upon termination, distributions will be made to the current Primary Beneficiaries as if there had been no severance.

The trustees of each sub-trust retain the discretionary standard contained in the Trust to distribute principal to the Primary Beneficiary or Beneficiaries of that sub-trust. In the event the trustees of a sub-trust determine that a discretionary distribution of principal to a Primary Beneficiary of the sub-trust should be made, the trustees of the other two sub-trusts created from the same Trust as a result of the severance are required to distribute to such Primary Beneficiary a pro rata portion of such discretionary principal distribution so that the source of funds for any discretionary principal distribution will remain identical and unchanged both before and after the severance.

State Statute 2 authorizes the conversion of an income trust to a total return trust if the trustee or a court determines that the conversion will enable the trustee to better carry out the purposes of the trust and is in the best interest of the trust beneficiaries. State Statute 2 provides that the trust distribution amount may not be less than the net income of the trust. The conversion of the income trust to a total return trust changed the definition of income distributable annually by the Trust and sub-trusts to the greater of net trust accounting income or a five percent unitrust amount determined on a three-year average basis in accordance with State law. The trustees and the Primary Beneficiaries determined and agreed that the conversion to a total return trust would enable the trustees to better carry out the purposes of the Trust and would be in the interest of the beneficiaries.

On Date 6, State Statute 2 was amended by prospectively deleting the requirement that trust distributions may not be less than the net income of the trust.

The following rulings have been requested:

- (1) The exercise of the trustees' power to sever the Trust on a fractional basis into three separate sub-trusts in accordance with State law will not adversely affect the Trust's status as exempt from the GST tax and the three sub-trusts created as a result of the severance will remain exempt from the GST tax;
- (2) The exercise of the trustees' power to convert the Trust and sub-trusts to total return trusts in accordance with the total return trust provisions of State law, distributing after conversion an annual amount equal to the greater of net trust accounting income or five percent of trust asset value, will not adversely affect the Trust's status as exempt from the GST tax, and the sub-trusts created as a result of the severance will remain exempt from the GST tax;
- (3) A subsequent modification of the Trust and sub-trusts in accordance with State Statute 2, as amended, to provide that the trusts distribute an annual amount equal to a five percent unitrust amount and remove prospectively the requirement that distributions not be less than net income, if made in accordance with State law, will not adversely affect the

trusts' status as exempt from the GST tax. However, since such modification is not required by State law, such modification is not necessary to maintain the trusts' status as exempt from the GST tax;

(4) The exercise of the trustees' power to sever the Trust on a fractional basis into three separate sub-trusts in accordance with State law will not cause the Trust, the sub-trusts or their beneficiaries to realize gain or loss from the sale or other disposition of property under § 1001 of the Code;

(5) The exercise of the trustees' power to convert the Trust and sub-trusts to unitrusts in accordance with the total return trust provisions of State law distributing after conversion an annual amount equal to the greater of net trust accounting income or five percent of trust asset value, will not cause the Trust, the sub-trusts, or their beneficiaries to realize gain or loss from the sale or other disposition of property under § 1001;

(6) After the severance of the Trust, each asset of each sub-trust has the same basis and holding period that it had in the Trust; and

(7) After the severance of the Trust into three separate sub-trusts, each sub-trust is treated as a separate taxpayer under § 643(f).

Ruling Requests 1, 2, and 3:

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

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

Under § 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, the generation-skipping transfer tax provisions do not apply to any generation-skipping transfer under a trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985. However, this exemption does not apply if additions (actual or constructive) are made to the trust after September 25, 1985.

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

present case, the Trust is considered to have been irrevocable on September 25, 1985, because neither § 2038 nor § 2042 applies.

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)(1) 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)) 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, if 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 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 26.2601-1(b)(4)(i)(D)(2) provides that for purposes of this section, a modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust 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. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust. In addition, administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the

trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)-1.

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 terms are identical except for the identity of the beneficiaries. 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 § 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 of the Internal Revenue Code.

Section 26.2601-1(b)(4)(i)(E), Example 8, illustrates a situation where a trust that is otherwise exempt from the GST tax provides that trust income is payable to A for life, and upon A's death, the remainder is to pass to A's issue, per stirpes. In 2002, the appropriate local court approves a modification to the trust that converts A's income interest into the right to receive the greater of the entire income of the trust or a fixed percentage of the trust assets valued annually (unitrust interest) to be paid each year to A for life. The example concludes that the modification does not result in a shift in beneficial interest 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. Rather, the modification can only operate to increase the amount distributable to A and decrease the amount distributable to A's issue. In addition, 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. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

Section 26.2601-1(b)(4)(E), Example 11, considers a situation where a trust that is otherwise exempt from the GST tax provides that trust income is payable to A for life and, upon A's death, the remainder is to pass to A's issue, per stirpes. State X, the situs of the trust, then amends its income and principal statute to define income as a unitrust amount of 4 percent of the fair market value of the trust assets valued annually. The example concludes that the administration of the trust, in accordance with the state statute defining the income to be a 4 percent unitrust amount will not be considered to shift a beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. Further, under the facts of the

example, no trust beneficiary will be treated as having made a gift for federal gift tax purposes, and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes.

In the present case, the Trust was established and became irrevocable on Date 1, and there have been no additions made to the Trust after September 25, 1985. Accordingly, the Trust is exempt from the GST tax under § 26.2601-1(b)(1).

Based on the facts submitted and the representations made, the severance of the Trust into three sub-trusts as described above, does not result in a shift of any beneficial interest in the Trust to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the division. Further, the severance does not extend the time for vesting of any beneficial interest beyond the period originally provided for under the terms of the Trust.

The conversion of the Trust and sub-trusts to total return trusts does not result in a shift of any beneficial interest to any beneficiary who occupies a lower generation than the beneficiaries holding the beneficial interests prior to the modification. Further, the conversion to total return trusts does not extend the time for vesting of any beneficial interest beyond the period originally provided for under the terms of the Trust. Accordingly, the severance and conversion to total return trusts does not cause the Trust or the sub-trusts to lose their GST exempt status.

Furthermore, a subsequent modification of the Trust and sub-trusts in accordance with State Statute 2, as amended, to provide that the trusts distribute an annual amount equal to a five percent unitrust amount and remove prospectively the requirement that distributions not be less than net income, if made in accordance with State law, will not adversely affect the trusts' status as exempt from the GST tax. However, since State law does not require such modification, such modification is not necessary to maintain the trusts' status as exempt from the GST tax.

Ruling Requests 4 and 5:

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

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in § 1011 for determining gain, and the loss is the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized. Under § 1001(c), the entire amount of gain or loss must be recognized, except as otherwise provided.

Section 1.1001-1(a) of the Income Tax Regulations provides that, except as otherwise provided in subtitle A of the Code, 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 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 of the transaction. Thus, neither gain nor loss is realized on a partition. See Rev. Rul. 56-437, 1956-2 C.B. 507.

An exchange of property results in the realization of gain or loss under § 1001 if the properties exchanged are materially different. *Cottage Savings Association 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 did embody 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 § 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.

Based on the information submitted and the representations made in the ruling request, the severance of the Trust does not result in a material difference in the legal entitlements enjoyed by any of the Trust beneficiaries. Likewise, a conversion from an income interest to a unitrust interest as described above will not cause the beneficiaries to have materially different or additional rights to the Trust. Accordingly, no gain or loss is recognized on the severance and modification of the Trust for purposes of § 1001.

Ruling Request 6:

Section 1015(b) provides that if property is acquired by a transfer in trust (other than a transfer in trust by a 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 1.1015-2(a)(1) provides that in the case of property acquired after December 31, 1920, by transfer in trust (other than by transfer in trust by gift, bequest, or devise) the basis of property so acquired is the same as it would be in the hands of the grantor increased by the amount of gain or decreased in the amount of loss recognized to the grantor on the transfer under the law applicable to the year in which the transfer was made. If the taxpayer acquired the property by transfer in trust, this basis applies whether the property be in the hands of the trustee, or the beneficiary, and whether acquired prior to termination of the trust and distribution of the property, or thereafter.

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 such property was held by any other person, if under Chapter 1 of Subtitle A of the Internal Revenue Code such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person. See also § 1.1223-1(b) of the Income Tax Regulations.

Based upon the information submitted and representations made, we conclude that because § 1001 does not apply to the severance and conversion of the Trust assets, under § 1015, the basis of the sub-trusts' assets and unitrusts' assets will be the same after the severance and conversion as the basis of those assets before the severance and conversion. Furthermore, pursuant to § 1223(2) the holding periods of the assets in the hands of the sub-trusts will include the holding periods of the assets in the hands of the Trust.

Ruling Request 7:

Section 643(f) provides that under regulations prescribed by the Secretary, two or more trusts shall be treated as one trust if: (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose of such trusts is the avoidance of federal income tax.

Based on the facts submitted and representations made, we conclude that while the sub-trusts will have the same grantor, they have different primary beneficiaries and will be managed and administered separately. Therefore, we conclude that the sub-trusts will be treated as separate trusts for federal income tax purposes.

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. If there is a change in material fact or law (local or federal) before the transactions considered in this ruling take effect, the ruling will have no force or effect. 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.

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. In addition, no opinion is expressed or implied with respect to the income tax consequences of any transaction.

These rulings are 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.

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

Sincerely,

Melissa C. Liquerman
Branch Chief, Branch 9
Office of Associate Chief Counsel

(Passthroughs & Special Industries)

Enclosure:

Copy for section 6110 purposes