

Internal Revenue Service

Number: **200743017**
Release Date: 10/26/2007

Index Number: 2601.04-01, 2501.01-00,
1001.00-00, 61.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

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Refer Reply To:
CC:PSI:B04
PLR-132705-06

Date:
June 08, 2007

In Re:

Legend

- Decedent -
- Spouse -
- Child A -
- GCA1 -
- GCA2 -
- GCA3 -
- GCA4 -
- Child B -
- GCB1 -
- GCB2 -
- Trust -
- Trust A1 -

- Trust A2 -

- Trust A3 -

- Trust A4 -

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Date 1 -
 Date 2 -
 Date 3 -
 Date 4 -
 Date 5 -
 State X -

Dear :

This is in response to the letter from your authorized representative dated April 10, 2006, and subsequent correspondence, in which you requested rulings with respect to the federal income, gift, and generation-skipping transfer (GST) tax consequences of a proposed modification of four trusts.

On Date 1, prior to September 25, 1985, Decedent died testate survived by Spouse, Child A, Child B, Child A's four children GCA 1, GCA 2, GCA 3, and GCA 4, and Child B's two children, GCB 1 and GCB 2. Child A subsequently died on Date 2 and Spouse died on Date 3.

Decedent's will established Trust, an irrevocable trust for the benefit of Spouse, Decedent's issue and Decedent's sister (who predeceased Decedent). Trust is governed by the laws of State X. After Spouse's death, the trustees are directed to divide Trust into two equal shares: one share for the benefit of Child A and Child A's issue, and one share for the benefit of Child B and Child B's issue. From each share the trustees are to pay the Decedent's child for whom the share is established and the child's issue all or any portion of the net income as the trustees deem advisable, and also portions of the principal as the trustees deem necessary or advisable for the beneficiaries' needs. The trustees are not required to take into account the beneficiaries' other resources or maintain equal or proportionate payments among the beneficiaries.

Trust is to terminate 20 years after the death of the survivor of Spouse, Child A, Child B, and the six grandchildren living on Date 1, i.e., GCA1, GCA2, GCA3, GCA4, GCB1 and GCB2. Upon termination, the trust estate is to be distributed to the then living issue, per stirpes.

Upon Spouse's death, Trust was divided into two equal shares, one for the benefit of Child B and his issue, and the other for the benefit of the issue of Child A.

On Date 4, the appropriate local court in State X issued an Order modifying certain dispositive provisions of Trust. The purpose of the modification was primarily to

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divide Child A's share of Trust into four equal subtrusts (referred to as the Grandchild's Trust or, collectively, as the Grandchildren's Trusts), one for the benefit of each of Child A's four children, so that each subtrust could implement different investment programs that best-suited the beneficiary of that subtrust. Trust A1 was established for the benefit of GCA1 and GCA1's descendants, Trust A2 for the benefit of GCA2 and GCA2's descendants, Trust A3 for the benefit of GCA3 and GCA3's descendants, and Trust A4 for the benefit of GCA4 and GCA4's descendants.

Trust, as modified on Date 4, also provided that any distribution of net income from a subtrust to a current beneficiary of a subtrust will be made at the discretion of the trustees of all four subtrusts and will be charged equally to each of the subtrusts. In addition, to the extent that any subtrust is exhausted, any distribution of net income to a current beneficiary of a subtrust, including the beneficiary of an exhausted subtrust, will be charged equally to the remaining subtrusts. On Date 5, the Internal Revenue Service issued a letter ruling concluding that the Date 4 modification did not result in a transfer for gift tax or generation-skipping transfer tax purposes and did not cause recognition of gain or loss for income tax purposes.

Trust was created and irrevocable before September 25, 1985 and It is represented that that no additions, actual or constructive, have been made to Trust or any of the resulting subtrusts since September 25, 1985.

The trustees of Trust and Trusts A1, A2, A3, and A4 propose to file a petition in the appropriate court in State X to modify Trusts A1, A2, A3, and A4, to provide that distributions of net income from each subtrust to a beneficiary of that subtrust are to be charged solely to that subtrust rather than being apportioned equally among all four subtrusts. In addition, the petition will request clarification of the distribution provisions upon termination of Trust and the subtrusts.

Specifically, the modified dispositive provisions of Trust will read as follows:

- (i) The Trustees shall, until termination of any Grandchild's Trust, pay to or for the benefit of an income beneficiary who shall be surviving from time to time of the child of [Child A] for whom such trust is held and such child's issue all of such net income of said Grandchild's Trust or any portion of such net income as the Trustees shall deem advisable (subject to a charge against net income of one-half (1/2) of the payment provided for my said sister in Paragraph A(1) divided by the number of Grandchildren's Trusts in existence at the time the payment to my said sister is required). Any distribution of net income from a Grandchild's Trust to a current income beneficiary of a Grandchild's Trust will be made at the discretion of the Trustees of such Grandchild's Trust.

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- (ii) The Trustees shall make a distribution of a portion of the principal of a Grandchild's Trust to the income beneficiary of a Grandchild's Trust, in such amounts and at such times as the Trustees shall in their discretion deem necessary or advisable, in accordance with the income beneficiary's needs as determined by the Trustees in their discretion with or without consideration of such income beneficiary's other resources.
- (iii) The Trustees of the four Grandchildren's Trusts have no obligation to keep the payments of income and principal to the current income beneficiaries of the four Grandchildren's Trusts, equal or proportionate, and shall accumulate all surplus net income and may add the same to the principal of the Grandchild's Trust that earned the net income.
- (iv) In the event the last surviving beneficiary of any Grandchild's Trust dies prior to the termination of the trust (as provided in Paragraph B, below) the remaining assets of such Grandchild's Trust shall be distributed on a pro rata basis to and held as part of the remaining Grandchildren's Trusts which then have surviving beneficiaries.
- (B) Each trust created hereunder, (including the four Grandchildren's Trusts) shall terminate twenty (20) years after the death of the last survivor of [Spouse] and my issue living on the date of my death. Upon such termination, the Trustees shall distribute the trust estate as follows:
 - 1. The share for the benefit of [Child B] shall be distributed to her issue, per stirpes by right of representation in each generation and not per capita.
 - 2. Each Grandchild's Trust shall be distributed to the issue of the respective child of [Child A] for whom provided, per stirpes by right of representation in each generation and not per capita. In default of such issue, such Grandchild's Trust shall be distributed to the then living issue of [Child A], per stirpes by right of representation in each generation and not per capita.

Under the terms of the trusts as modified, the beneficiaries of distributions from each trust prior to and upon termination will be limited to the primary beneficiary of the respective trust and that beneficiary's issue. Thus, distributions from Trust A1 will be limited to GCA1 and GCA1's issue; distributions from Trust A2 will be limited to GCA2 and GCA2's issue; distributions from Trust A3 will be limited to GCA3 and GCA3's issue; and distributions from Trust A4 will be limited to GCA4 and GCA4's issue

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The petition to the appropriate local court will request that any order issued by the court is contingent based on the Internal Revenue Service issuing a favorable private letter ruling on the issues presented.

The following rulings have been requested:

1. The proposed modification will not cause the original remaining trust share [for the benefit of Child B and Child B's issue] and the four separate subtrusts for the benefit of the children of Child A [Trust A1, Trust A2, Trust A3, and Trust A4] established under the terms of Trust to lose their exempt status for federal generation-skipping transfer tax purposes and will not subject the original remaining trust share, the four subtrusts, or their distributions to the GST tax.
2. The proposed modification will not cause Trust, any subtrust (Trusts A1, A2, A3, or A4) or any beneficiary of Trust or any subtrust to recognize gain or loss from the sale or disposition of property under §§ 61 or 1001.

LAW and ANALYSIS:

ISSUE 1:

Section 2601 of the Internal Revenue Code imposes a tax on every generation-skipping transfer (GST).

Section 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations provides in part that the GST tax does not apply to any generation-skipping transfer under a trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985. This rule 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)(A) provides that, except as provided in § 26.2601-1(b)(1)(ii)(B) or (C), any trust (as defined in § 2652(b)) in existence on September 25, 1985, is considered an irrevocable trust.

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 under § 26.2601-1(b) will not cause the trust to lose its exempt status. The regulation provides that the rules contained in the paragraph are generally applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. Except as otherwise provided, 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

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included in the gross estate of a beneficiary, or may result in the realization of capital gain.

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 § 26.2601-1(b)(4)(i)(D), 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 generation-skipping transfer or the creation of a new generation-skipping 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.

Section 26.2601-1(b)(4)(i)(E), Example 5, considers a situation where, in 1980, Grantor established an irrevocable trust for the benefit of his two children, A and B, and their issue. Under the terms of the trust, 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 principal to A and A's issue in such amounts as the trustee deems appropriate. On A's death, the trust principal is to be distributed equally to A's issue, per stirpes. If A dies with no living descendants, the principal will be added to the trust for B and B's issue. The trust for B and B's issue is identical (except for the beneficiaries), and terminates at B's death at

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which time the trust principal is to be distributed equally to B's issue, per stirpes. If B dies with no living descendants, principal will be added to the trust for A and A's issue. 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.

In the present case, Trust was irrevocable on September 25, 1985, and it is represented that no additions, actual or constructive, have been made to Trust or any subtrust created under the terms of Trust, after that date. The modification on Date 4 provided for the division of Child A's share of Trust into four equal subtrusts, one for the benefit of each of Child A's children. That division allowed each child of Child A to pursue their separate investment strategies with their separate subtrusts but required that distributions of income and principal be allocated equally among each of the four subtrusts. The IRS concluded on Date 5 that the Date 4 modification did not result in a transfer for gift tax or generation-skipping transfer tax purposes and did not cause recognition of gain or loss for income tax purposes.

The proposed modification will cause distributions of income and principal to the beneficiary of a subtrust be made solely from that subtrust, rather than being allocated among the other subtrusts, and clarifies that distribution of trust estate upon termination of a subtrust be made solely to the current beneficiary of that subtrust, rather than beneficiaries of each subtrust established from Child A's share of Trust. As is the case in §26.2601-1(b)(4)(i)(E), Example 5, the proposed modification will not result in the shift of beneficial interest in the subtrust to a beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the division, and will not extend the time for vesting of any beneficial interest. Similarly, the modification providing for the distribution of the subtrust corpus to the current beneficiary of that subtrust will not result in the shift of beneficial interest in the subtrust to a lower generation beneficiary and will not extend the time for vesting of any beneficial interest.

Therefore, based on the facts submitted and the representations made, we conclude that the proposed modification of Trust, Trusts A1, A2, A3 and A4 will not cause Trust, Trusts A1, A2, A3 and A4 to lose their exempt status for generation-skipping transfer tax purposes of § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i). In addition, the proposed modification of Trust, Trusts A1, A2, A3, and A4 will not cause any distributions from those trusts to be subject to generation-skipping transfer taxes under § 2601. Accordingly, after the proposed modification, Trust, Trusts A1, A2, A3 and A4 will continue to be exempt from the GST tax imposed under § 2601 provided there are no additions to those trusts after September 25, 1985.

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ISSUE 2:

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 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, 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.

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 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.

Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), provides that an exchange of property results in the realization of gain or loss under § 1001 if the properties exchanged are materially different. 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 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.

In the present case, provided that State X court approves the petition for modification, it is consistent with the Supreme Court's opinion in Cottage Savings to find that the interests of the beneficiaries of the modified trusts will not differ materially from their interests in Trust. Except for the changes described above, all other provisions of Trust will remain unchanged. Consequently, the proposed modification will not result in a material difference in kind or extent of the legal entitlements enjoyed by the beneficiaries.

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Accordingly, based on the facts submitted and representations made, we conclude that the proposed modification will not cause Trust, any subtrust or any beneficiary of Trust or any subtrust to recognize gain or loss from the sale or disposition of property under §§ 61 or 1001 for federal income tax purposes.

We are not expressing any opinion concerning the gift tax consequences of the proposed transaction. 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(s) requesting it. Section 6110(k)(3) 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.

This ruling is directed only to the taxpayers 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
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure

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