Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:4-PLR-130870-01
Date:
December 03, 2001

Re:

LEGEND:

Trustor =

Son =

Daughter =

E =

F =

G =

H =

I =

Child 1, 2, & 3 =

Child 4, 5, 6, & 7 =

Trustee =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Year 1 =

Year 2 =

Year 3 =

Account 1 =

Account 2 =

Dear :

This is in response to your correspondence dated June 1, 2001, and subsequent correspondence requesting a ruling concerning the income, gift, and generation-skipping transfer tax consequences of the proposed severance of Trust under sections 1001, 2501, and 2601 of the Internal Revenue Code.

The facts and representations submitted are summarized as follows: Trust was created on Date 1 by Trustor. Trustee, a bank, was the original trustee and continues to serve as trustee of Trust. The corpus of the Trust is held in two accounts maintained at the Trustee. Under Section Tenth of Trust, as amended, Trustor reserved the power to amend Trust. The original Trust agreement has been amended by seven written amendments. Trust became irrevocable upon Trustor's death on Date 2.

During the lifetime of Trustor, Trustor was to receive the income from Trust. Upon Trustor's death, under the terms of Trust as amended by the Fifth Amendment to Trust, the residue of Trust is to be held for the use and benefit of Trustor's son, Son, and Son's issue (G, H, and I) and the issue (E and F), of Trustor's deceased daughter, Daughter. Trustee is to pay to Son, annually, for his lifetime, three-fifths of the net income of Trust. Trustee is to pay to E and F, and after the death of Son, to G, H, and I, annually, so long as each grandchild of Trustor lives, at least quarterly, such sum as the Trustee, with the consent and approval of the advisors to Trustee in its discretion may determine proper for the support, maintenance, education, use or benefit of such grandchild of Trustor, up to but not exceeding one-fifth of the net income of the Trust estate for the year in which payment is made, not to exceed $3,000, except when the Trustee, with the consent and approval of the Advisors, determines an emergency exists requiring payment of a greater sum, until such grandchild has attained the age of thirty-five.

On Date 3, Son died and his children G, H, and I became income beneficiaries of Trust. Thus, after the death of Son, Trust had five income beneficiaries (collectively, the “Income Beneficiaries”) who were the grandchildren of the Trustor.

Subsection 6 of Section Third of Trust Agreement, as modified by the Fifth Amendment, states that as each Income Beneficiary dies, “the corpus of the trust estate shall be divided into as many parts as there were grandchildren living immediately prior to the death of such deceased grandchild, and one of such parts shall thereupon absolutely vest in the lawful issue [(the “Remainder Beneficiaries”)] then living of the grandchild then deceased, taking by representation in all cases, per stirpes and not per capita... .” In the event any of the five Income Beneficiaries dies without issue, “such interest shall remain a part of the corpus of the trust estate, and the principal thereof and the income therefrom shall be held and accumulated by the Trustee and distributed as a part of the corpus of the trust estate.”

Income Beneficiary H died without issue in Year 1, and pursuant to Section Third, above, the principal of his share and the accumulated income therefrom remained as a part of the Trust Estate corpus in a separate account for distribution as each other grandchild of the Trustor died. Income Beneficiary E died in Year 2. At that time, one-fourth of the then-remaining principal of Trust was distributed to her issue, per stirpes. Income Beneficiary I died in Year 3. At that time, one-third of the then remaining principal of Trust was distributed to his issue, per stirpes. The two remaining Income Beneficiaries of Trust, G and F, are both still living. Child 1, Child 2, and Child 3 are the children of G. Child 4, Child 5, Child 6 and Child 7 are the children of F.

In the event any of the children of G or F predecease his or her parent, that child’s issue become the Remainder Beneficiaries of that child’s share. At present, there are twelve living issue of the above seven children of the Income Beneficiaries, G and F. If all of G’s issue or all of F’s issue predecease them, then that Income Beneficiary’s share would be divided among the other Trust beneficiaries as provided in Trust, as amended.

The Second Paragraph of Trust, as amended by the Seventh Amendment, governs the appointment of Trust Advisors, whose consent is required for certain activities and who are charged with ensuring that the provisions of the Trust agreement are carried out. Currently, G is the sole Trust Advisor.

The Trust was funded by gifts of property made during the period between the creation of the Trust and the death of the Trustor. No additions have been made to the Trust after September 25, 1985. The Thirteenth Section of Trust, subsection 3, which is unmodified by amendments, provides that, with the consent of the Advisors to the Trustee the Trustee may invest and reinvest any money at the time received by the Trustee and constituting part of the principal or income of the trust thereby created in such securities as the Trustee, with the consent of the Advisors to the Trustee, may deem advisable. Such investment shall not be restricted to the investments for Trustees fixed by any state or rule of law of the State, or any other state.

In order to tailor investment policy to meet the particular needs of one of the Income Beneficiaries (G) and his issue in comparison to the needs of the other Income Beneficiary (F) and her issue, Trustee sought and received an order of the Court of Chancery of State dated Date 4 (the “Order”) permitting the two Trust accounts (“Account 1" and “Account 2") to each be divided into two equal parts corresponding to the two remaining income beneficiaries, G and his issue, and F and her issue. The parts that correspond to F were further divided into four additional shares. Each of the parts corresponding to G will be held as a separate trust for the benefit of G and his issue, but otherwise upon the same terms and conditions as provided under the terms of Trust, as amended. The four shares relating to Account 1 and corresponding to F will be held as four separate trusts, each for the benefit of F and one of her children and their respective issue, so that each child and his/her respective issue would have one trust relating to Account 1 for their benefit, but otherwise upon the same terms and conditions as provided under the terms of Trust, as amended. Similarly, the four shares relating to Account 2 and corresponding to F will be held as four separate trusts, each for the benefit of F and one of her children and their respective issue, so that each child and his or her respective issue would have one trust relating to Account 2 for their benefit, but otherwise upon the same terms and conditions as provided in Trust, as amended. The trusts for F and each of her children and their respective issue are collectively referred to as “subtrusts.”

At present, the income of Trust is currently distributed to the two surviving Income Beneficiaries pursuant to the terms of Trust, as amended. Upon the death of the next to die of the Income Beneficiaries, the Trust corpus is to be divided into two parts. The issue of the deceased Income Beneficiary would then receive one-half of the then existing Trust corpus outright and free of trust <u>per stirpes</u>. The remaining share would remain in trust until the death of the last Income Beneficiary, at which time his or her issue would receive the remaining trust corpus outright and free of trust.

Accordingly, the above Order allows Trust to be partitioned immediately in the same manner in which it would be divided upon the death of the next to die of the remaining Income Beneficiaries. Upon division of Trust into two shares, one Income Beneficiary and his or her issue would become beneficiaries of a share.

Concerning the proposed further division of that part or share of the trust for the benefit of Income Beneficiary F into four subtrusts, the submission provides that each subtrust will then be held for the benefit of F, one of her children and the issue of such child. The submission maintains that the subdivision of the Trust is consistent with the distribution scheme set forth in Trust because, under that agreement, upon the death of F, her one-half of the then existing Trust corpus would be divided among her issue on a <u>per stirpes</u> basis and distributed outright and free of trust.

It is represented that all trusts created under the Order will be held under the same terms and conditions as provided in Trust, as amended. The assets in Trust will be divided among the trusts created under the Order on a pro rata basis. The last day of the tax year of Trustor, Trust and the Beneficiaries is December 31. All taxpayers use the cash method of accounting.

The following rulings are requested:

1. Neither the original Trust nor any beneficiary will realize gain or loss under section 1001 as a result of the partition of Trust into subtrusts pursuant to the Order.

2. The partition of Trust into separate trusts pursuant to the Order granted by the Court of Chancery of State will not affect the grandfathered status of Trust or the resulting trusts for generation-skipping transfer tax purposes under section 2601.

3. No taxable gift under section 2501 will be made by any beneficiary of Trust as a result of the partition of Trust into subtrusts pursuant to the Order.

LAW AND ANALYSIS

Ruling 1. 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 section 1011 for determining loss over the amount realized.

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.

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 thereof. Thus, neither gain nor loss is realized on a partition. See Rev. Rul. 56-437, 1956-2 C.B. 507.

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 sections 1001 and 1002.

The present case is distinguishable from Rev. Rul. 69-486 because the assets of Trust will be divided pro rata between the two parts or shares of the trust, and then allocated pro rata among the subtrusts created out of one such part or share. Accordingly, the proposed transaction will not be treated as a pro rata distribution followed by an exchange of assets among the beneficiaries of the original Trust.

Cottage Savings Ass'n 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 in Cottage Savings, 499 U.S. at 560-61, concluded that section 1.1001-1 of the regulations 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 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.

It is consistent with the Supreme Court's opinion in Cottage Savings to find that the interests of the beneficiaries, both Income and Remainder, in the two parts or shares of the Trust resulting from the division (and of F and her four children in the subtrusts resulting from the division of her share or part of Trust), will not differ materially from their interests in the original Trust. The proposed transaction will not change the interests of the beneficiaries. Instead, the beneficiaries will be entitled to the same benefits after the proposed transaction as before. The transaction here is similar to the kinds of transactions discussed in Rev. Rul. 56-437, since the Trust here is to be divided, but all other provisions of the Trust will remain unchanged, other than changes described above in the facts section which are necessary to ensure that the beneficiaries of the Trust will be entitled to the same benefits as before. 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, the conclusion that the proposed division will not result in a material change is unaffected by the fact that it is anticipated that after the division, the trustee of the subtrusts may cause the subtrusts to invest in dissimilar assets.

Therefore, the division of the Trust into two equal parts and the further division of one such part into subtrusts, and the pro rata allocation of each existing asset between the two parts and subtrusts, will not result in the realization of any gain or loss under section 1001 by the Trust, the subtrusts, or any of the beneficiaries.

Ruling 2. Section 2601 imposes a tax on every generation-skipping transfer (GST), which is defined under section 2611 as a taxable distribution, a taxable termination, or a direct skip.

Section 1433(b)(2)(A) of the Tax Reform Act of 1986 (the Act), 1986-3 (Vol. 1) C.B. 1, and section 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 was 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)(iv) provides that if an addition is made after September 25, 1985, to an irrevocable trust which is excluded from chapter 13 by reason of section 26.2601-1(b)(1), 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 section 26.2601-1(b)(1), (2), or (3), will not cause the trust to lose its exempt status. The rules of section 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. 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 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 — (1) 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 (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. A modification of an exempt trust will result in a shift in a 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.

Section 26.2601-1(b)(4)(i)(E), Example 5, illustrates a situation where a trust that is otherwise exempt from the GST tax is divided into two trusts. Under the facts presented, 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 interests prior to the division, and 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. Accordingly, the two partitioned trusts will not be subject to the provisions of chapter 13.

In this case, Trustor's Trust was irrevocable on September 25, 1985. It is represented that no additions to Trust have been made since September 25, 1985.

Based on the facts presented and the representations made, the division of Trust, pursuant to the court's Order, into two trusts, one for the benefit of F and F's heirs, and one for the benefit of G and G's heirs, and the further division of the trust for the benefit of F and F's heirs into subtrusts, one each for the benefit of F and one of F's four children will not result in a shift of any beneficial interest in Trust to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the division. Further, the proposed division will not extend the time for vesting of any beneficial interest in the new trusts beyond the period provided for under the original Trust. Accordingly, we conclude that the partition of Trust into separate trusts in compliance with Order will not affect the grandfathered status of Trust or the resulting trusts for generation-skipping transfer tax purposes pursuant to section 2601.

Ruling 3. Section 2501(a)(1) provides that a tax, computed as provided in section 2502, is hereby imposed for each calendar year on the transfer of property by gift during such calendar year by any individual, resident or nonresident.

Section 2511(a) provides that subject to the limitations contained in chapter 12, the gift tax imposed by section 2501 will apply 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 will be considered the amount of the gift. Section 2512(b) states that where property is transferred for less than adequate and full consideration in money or money's worth, the amount by which the value of the property exceeds the value of the consideration received shall be deemed a gift.

In this case, as described above, the division of Trust assets between the subtrusts will not result in any change in the beneficial interests of any of the trust beneficiaries.

Accordingly, based on the facts submitted and representations made, the division of Trust into the subtrusts, pursuant to the court's Order will not cause any beneficiary of Trust or any of the subtrusts to have made a taxable gift for federal gift tax purposes under section 2501.

In accordance with the power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

A copy of this letter should be attached to any gift, estate, or GST tax returns that you may file relating to this matter.

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 the appropriate party. While this office has not verified any part of the material submitted in support of the request for rulings, it is subject to verification and examination.

Except has specifically ruled above, no opinion is expressed as to the federal tax consequences of the facts described above under the cited provisions or any other provisions of the Code or regulations.

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.

Lorraine E. Gardner
Acting Senior Technician Reviewer
Branch 4
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure
Copy of letter for section 6110 purposes