Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
January 23, 2002

Re:

LEGEND:

Original Trust	=
Date 1	=
Decedent	=
Spouse	=
Daughter	=
Son	=
State	=
Date 2	=
Year 1	=
Year 2	=
Grandchildren	=
Successor Trust 1	=
Successor Trust 2	=
Trustee	=
Probate Court	=
Date 3	=

Dear

In a letter dated September 28, 2001, you requested rulings concerning the income and generation-skipping transfer ("GST") tax consequences of a judicial division and modification of an irrevocable trust into two separate and equal successor trusts. This letter responds to your request.

The information submitted and the representations made are summarized as follows: On Date 1, Decedent created an irrevocable living trust under the laws of State (the "Original Trust") for the benefit of Spouse, Daughter, and Son. Decedent died on Date 2.

Article Ninth, Paragraph Three, of the Original Trust provides that during Spouse's lifetime, the trustee shall pay to Spouse as often as quarterly one-half of the net income of the trust.

Article Ninth, Paragraph Five, provides that upon each child reaching age twenty-one, the trustee may advance to either Daughter or Son, out of the share of principal from which each child is receiving income, such part of the trust principal as the trustee deems necessary or advisable for the benefit of such child, provided the trustee reduces such child's income payments accordingly.

Article Ninth, Paragraph Seven, provides that upon Spouse's death, the trustee shall segregate the Original Trust's income into two equal shares, one for Daughter and one for Son.

Article Ninth, Paragraph Eight, provides that in the event of the death of either Daughter or Son during the life of the trust estate, such deceased child's share of income shall be paid to his or her descendants, per stirpes.

Article Ninth, Paragraph Nine, provides that the Original Trust shall continue until the death of the survivor of Spouse, Daughter and Son. At the death of such survivor, the Original Trust will terminate and the remaining trust property will be distributed to the then-surviving descendants, per stirpes, of Daughter and Son. If one of Decedent's children is not survived by descendants, the entire trust estate will be distributed to the then-surviving descendants of the other child.

Article Ninth, Paragraph Ten, provides that if at the termination of the Original Trust neither Daughter, Son nor any of their descendants are surviving, the remaining trust property will be distributed to Decedent's brother. If Decedent's brother is not surviving, the property will be distributed to Daughter and Son's heirs at law in accordance with the laws of descent of State.

Spouse died in Year 1. Son died in Year 2 survived by six children (the "Grandchildren") and their descendants. Daughter is now 86 years old and has no descendants.

Trustee asserts that the respective interests of Daughter and the descendants of Son have become divergent and are now in conflict with respect to the investment of trust assets and the distribution of income. To resolve any differences, the income beneficiaries, the adult contingent income and remainder beneficiaries, and the minor, unborn or otherwise unascertained beneficiaries (through their guardian ad litem) agreed to a judicial division of the Original Trust into two separate and equal successor trusts, Successor Trust 1 and Successor Trust 2. This division reflects the current income beneficiaries' respective beneficial interests in the Original Trust.

Pursuant to the agreement, each of the successor trusts will assume an equal share of all outstanding liabilities of the Original Trust. Successor Trust 1 will be administered under the terms of the Original Trust. Successor Trust 2, however, will be modified to provide for payment to Son's descendants of an annual amount equal to the greater of (i) the entire net income of the trust, or (ii) the "Total Annual Return Amount." The Total Annual Return Amount will be determined by multiplying the average fair market value of the trust corpus of Successor Trust 2 as of the last day of the preceding three calendar years (less any liabilities of the trust for such preceding years and any undistributed amounts of income attributable to the preceding year) by four percent, provided, however, that the fair market value of the trust corpus for the years 1998, 1999 and 2000 shall be deemed to be one-half the fair market value of the Original Trust for the years 1998, 1999 and 2000.

Following the approval of the agreement by the various beneficiaries, Trustee submitted a petition to the Probate Court seeking approval of the agreement. On Date 3, the Probate Court issued a preliminary order approving the agreement. Pursuant to the preliminary order, the judicial division and modification of the Original Trust will become effective upon receipt of a favorable ruling from the Internal Revenue Service. The Probate Court's preliminary order also requires Trustee to file a petition and proposed final order within thirty (30) days following the receipt of a favorable private letter ruling regarding the tax consequences of the changes described in the agreement.

In addition to the aforementioned facts, Trustee represents that no other changes are to be made to the Original Trust and there have been no actual or constructive additions to the Original Trust after September 25, 1985.

Based on the foregoing, you have requested the following rulings:

1. The Original Trust is exempt from GST tax because it became irrevocable on or before September 25, 1985, and no additions (actual or constructive) have been made to the Original Trust since that date.

2. The implementation of the court-approved division of the Original Trust into Successor Trust 1 and Successor Trust 2 and the modification of Successor Trust 2 will not cause the Original Trust, the two successor trusts or any distributions therefrom to be subject to the GST tax.

3. The proposed division and modification of the Original Trust will not constitute taxable dispositions of trust assets by the Original Trust (or the two successor trusts) or of interests in the Original Trust by any of the beneficiaries of the Original Trust (or the two successor trusts) for purposes of § 1001 of the Internal Revenue Code.

RULINGS 1 and 2

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

Section 2611(a) defines the term "generation-skipping transfer" as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 26.2601-1(a)(1) of the Generation-Skipping Transfer Tax Regulations provides that except as otherwise provided in § 26.2601-1, the provisions of chapter 13 of the Internal Revenue Code of 1986 apply to any generation-skipping transfer (as defined in § 2611) made after October 22, 1986.

Section 26.2601-1(b)(1)(i) provides that the GST 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. 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, unless otherwise provided in either §§ 26.2601-1(b)(1)(ii)(B) or (C), any trust in existence on September 25, 1985, is considered an irrevocable trust.

Section 26.2601-1(b)(4) provides the 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) will not cause the trust to lose its exempt status.

Section 26.2601-1(b)(4)(i)(B) provides that a court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to the provisions of chapter 13, if – (1) the settlement is the product of arm's length negotiations; and (2) the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the positions of the litigating parties

and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.

Section 26.2601-1(b)(4)(i)(C) provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to be subject to the provisions of chapter 13, if – (1) the judicial action involves a bona fide issue; and (2) the construction is consistent with applicable state law that would be applied by the highest court of the state.

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 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.

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), which relate to property includible in the Decedent's gross estate under §§ 2038 and 2042. In the present case, the Original Trust is considered to have been irrevocable on September 25, 1985, because neither § 2038 nor § 2042 apply. Consequently, with regard to Ruling 1 we conclude that the Original Trust is not subject to the GST tax because it satisfies all of the requirements set forth in § 26.2601-1(b)(1).

With regard to Ruling 2, the terms of the Original Trust provide that the income beneficiaries shall receive all of the net income of their respective share of the Original

Trust. The order issued by the Probate Court calls for a division of the Original Trust into Successor Trust 1 and Successor Trust 2. The terms of the Original Trust will govern Successor Trust 1. However, Successor Trust 2 will be modified so that Son's descendants will be paid annually the greater of the net income of the trust or the Total Annual Return Amount. The proposed modification of Successor Trust 2 ensures that Son's descendants will receive at least as much income as they currently receive under the terms of the Original Trust. Furthermore, the modification and division of the Original Trust will not extend the time for the vesting of any beneficial interest in the trust beyond the period provided for under the terms of the Original Trust. Thus, the court-approved division and modification of the Original Trust satisfies the requirements of § 26.2601-1(b)(4)(i)(D).

Based on the foregoing, we conclude that the court-approved division of the Original Trust into Successor Trust 1 and Successor Trust 2 and the modification of Successor Trust 2 will not subject the Original Trust, Successor Trust 1, Successor Trust 2 or any distributions therefrom to the GST tax. We also conclude that the successor trusts and the distributions therefrom shall continue to be exempt from the GST tax provided no actual or constructive additions are made to the trusts.

RULING 3

Section 61(a)(3) provides that gross income means all income from whatever source derived, including gains derived from dealings in property.

Section 1.61-1 of the Income Tax Regulations provides that gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services.

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

Under § 1.1001-1(a), except as otherwise provided in Subtitle A, the 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 as loss sustained.

Case law supports the proposition that gain is realized only if properties exchanged are materially or essentially different. Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991). The issue in Cottage Savings was whether a financial institution realized tax deductible losses when it exchanged 90 percent participation interests in one group of residential mortgages for another lender's 90 percent participation interests in a different group of residential mortgages.

The Supreme Court of the United States reasoned that because the participation agreements exchanged derived from loans made by different obligors and were secured by different homes, the interests exchanged embodied legally distinct entitlements and hence were materially different. Therefore, the Court held that the taxpayer sustained tax deductible losses. Unlike the facts presented in Cottage Savings, the facts presented here involve a judicial division and modification of a trust under the State Code.

Based on the information submitted and the representations made in the ruling request, the assets and liabilities of the Original Trust will be divided and modified pursuant to the authority granted in the Uniform Prudent Investor Act of the State Code. Trust expenses will be allocated between income and principal pursuant to authority granted in the State Code. The pro rata division of the Original Trust into Successor Trust 1 and Successor Trust 2 and the modification of Successor Trust 2 will not cause the trust beneficiaries to have materially different or additional rights. The trust beneficiaries will hold essentially the same bundle of rights and succession of interests before and after the pro rata division and modification. No sale or other disposition of property will occur within the meaning of § 1001 as a result of the division and modification. Hence, no gain or loss will be realized by the Original Trust or its beneficiaries under §§ 61 or 1001 as a result of the division and modification.

Except as expressly provided herein, no opinion is expressed or implied concerning the federal tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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.

Pursuant to the Power of Attorney and Declaration of Representative on file with this office, a copy of this letter is being sent to taxpayer's representative.

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.

Sincerely,
James F. Hogan
Senior Technician Reviewer
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure
Copy for 6110 purposes