Internal Revenue Service

Number: **200417001**
Release Date: 4/23/04
Index Number: 1001.00-00; 2501.00-00; 2601.00-00

Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B04 – PLR-103607-03
Date: Dec. 3, 2003

In Re:

Legend:

Settlor =
Date 1 =
Trust =

Son 1 =
Son 2 =
Son 3 =
Son 4 =
Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Bank =
Year 1 =
Year 2 =
Grandchild 1 =
Grandchild 2 =
Grandchild 3 =

Date 2 =
Date 3 =
State =
Statute =

Dear :

This is in response to a letter dated December 30, 2002, and subsequent correspondence, requesting rulings regarding the income, gift, and generation-skipping transfer (GST) tax consequences of the proposed division of a trust.

Facts

The facts submitted and representations made are as follows. On Date 1, Settlor executed an irrevocable trust agreement (Trust) creating four separate equal trusts, Trust 1, Trust 2, Trust 3, and Trust 4, one for the benefit of each of Settlor's children, Son 1, Son 2, Son 3, and Son 4, respectively.

Under Section 1(a) of the Distributive Provisions of Trust, until a child of Settlor reaches age 21 or dies earlier, the net income of the child's trust will be accumulated unless the corporate trustee deems it requisite or desirable that any part of that income be used to meet the reasonable needs of the child. Under Section 1(b), when the child reaches age 21, the previously accumulated income will be added to principal and the current net income of the child's trust will be paid to the child for life. Under Section 1(c) of the Distributive Provisions, upon the death of the child, any amount of the net income of the child's trust as the corporate trustee will from time to time deem requisite or desirable will be paid to the deceased child's living issue, per stirpes, until the trust terminates under Section 2 of the Distributive Provisions or the death of the last survivor of those issue before that termination. Under Section 1(d) of the Distributive Provisions, upon the death of the child without any then living issue, or, if the child leaves issue, upon the death of the last survivor of those issue before termination of the trust, all of the then remaining assets of the trust will inure to the benefit of (i) Settlor's then living issue, per stirpes, or, if none; (ii) those then living among the three named daughters of Settlor's spouse or the then living issue, per stirpes, of a deceased daughter, or, if none; (iii) the then living issue, per stirpes, of Settlor's named brother, or, if none; (iv) a specified college, or its successor, for a specified use, or if not then in existence; (v) a specified university.

Under Section 1(f) of the Distributive Provisions, the corporate trustee may distribute principal to the current income beneficiary of any trust created under Trust, if, in its sole judgment, the corporate trustee determines that the available net income from that beneficiary's trust plus income (other than capital gains) readily available to that person from other sources is not sufficient to meet the reasonable needs of that beneficiary in that beneficiary's station in life.

Under Section 2 of the Distributive Provisions, unless sooner terminated under the above provisions, each trust must terminate upon the expiration of the period 21 years after the death of the last survivor among Settlor and the individual beneficiaries named or provided for under Section 1 who were alive when Trust was executed. Upon that termination, the then remaining assets of each trust will be distributed to (i) Settlor's then living issue, per stirpes, or, if none; (ii) those then living among the three named daughter's of Settlor's spouse or the then living issue, per stirpes, of a deceased daughter, or, if none; (iii) the then living issue, per stirpes, of Settlor's named brother, or, if none; (iv) a specified college, or its successor, for a specified use, or if not then in existence; (v) a specified university. Upon ultimate termination of Trust, the assets in each son's trust will be distributed among that son's then living issue, per stirpes, without being pooled and redivided among all of Settlor's issue.

Bank is named as the corporate trustee. Settlor was named as the individual trustee with four individuals named as his successors. In addition, each son of Settlor may qualify as a successor individual trustee upon reaching age 21. Among its powers, the corporate trustee is authorized to divide or allot all or any portion of the assets of the trusts in accordance with the terms of Trust in kind or in money or partly in kind and partly in money.

Settlor died in Year 1. Son 2 died in Year 2 survived by his three children, Grandchild 1, Grandchild 2, and Grandchild 3.

The trustees of Trust 2 for Son 2 plan to divide Trust 2 equally into three separate trusts, one for each of Grandchild 1, Grandchild 2, and Grandchild 3. The assets of Trust 2 will be distributed equally among the three successor separate trusts on a pro rata basis, unless, on the date of division, Trust 2 has outstanding loans to any among Grandchild 1, Grandchild 2, and Grandchild 3. Any such loan will be allocated to the separate trust created for the grandchild who borrowed money from Trust 2 with a corresponding cash allocation to the other separate trusts to ensure that each trust receives an equal share of the Trust 2 assets.

Under the proposed division, each of the successor trusts will apply for its own taxpayer identification number and will be administered under the terms of Trust except that each of the successor trusts will be held for the benefit of a different beneficiary and that beneficiary's issue. If any of Settlor's descendants for whom a separate successor trust has been established dies without issue before the termination date of Trust, the assets of that descendant's separate trust will be apportioned, per stirpes, among the then living issue of the deceased descendant's nearest lineal ancestor who has living issue and who is a lineal descendant of Settlor.

Upon the termination date of Trust, the separate trusts for Settlor's descendants will not be pooled with each other but will be distributed to the individual beneficiaries then eligible to receive income from such trusts in proportion to those income interests.

On Date 2, the trustees of Trusts 1-4 submitted a petition to the local court seeking judicial confirmation that the corporate trustee in its sole discretion is authorized to divide Trust 1, Trust 3, and Trust 4 under State Statute and seeking judicial approval of the proposed division of Trust 2. On Date 3, the local court issued the requested ruling, conditioned upon the trustees' receipt of a favorable ruling from the Internal Revenue Service.

No additions, actual or constructive, were made to Trust 1, Trust 2, Trust 3, and Trust 4 after September 25, 1985.

We have been asked to rule as follows:

1. The proposed division of Trust 2 will not constitute a sale or other taxable disposition of the assets of Trust 2 or of the successor trusts under § 1001.

2. The proposed division of Trust 2 will not result in a transfer by any of the beneficiaries of Trust 2 or of the successor trusts that is subject to gift tax under § 2501.

3. After the proposed division of Trust 2, the three successor trusts will be considered to have been created and to have become irrevocable before September 25, 1985, and will be exempt from generation-skipping transfer tax under Chapter 13.

4. The judicial confirmation of the corporate trustee's power to divide Trust 1, Trust 3, and Trust 4 (after the death of the son of Settlor for whom such trust is held) will not constitute a taxable disposition of the assets of those trusts for purposes of § 1001.

5. The judicial confirmation of the corporate trustee's power to divide Trust 1, Trust 3, and Trust 4 (after the death of the son of Settlor for whom such trust is held) will not result in a transfer by any of the beneficiaries of those trusts that is subject to gift tax under § 2501.

6. After the issuance of the Date 3 court order containing the judicial confirmation, Trust 1, Trust 3, and Trust 4 continue to be exempt from generation-skipping transfer tax under Chapter 13.

<u>Ruling Request #1</u>:

State Statute provides that trustees have the power to divide a trust into two or more separate trusts if:

> (i) the new trusts so created are not inconsistent with the terms of the governing instrument and (ii) the terms of the new trusts provide in aggregate for the same succession of interests and beneficiaries as are provided in the original trust. Funding of the new trusts created pursuant to the authority granted under this subdivision must either (i) be carried out by pro rata allocation of the assets of the original trust; (ii) be based upon the fair market value of the assets at the date of division; or (iii) be carried out in a manner fairly reflecting the net appreciation or depreciation of the trust assets measured from the valuation date to the date of division.

Section 61 of the Internal Revenue Code provides that gross income means all income from whatever source derived. 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 § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

Section 1001(b) provides that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property received.

Section 1001(c) provides that, except as otherwise provided in subtitle A, the entire amount of the gain or loss, determined under § 1001, on the sale or exchange of property shall be recognized.

Section 1.1001-1(a) of the Income Tax Regulations provides that 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.

Rev. Rul. 69-486, 1969-2 C.B. 159, involved two beneficiaries of a trust who by mutual agreement, requested that the trustee distribute all of the trust corpus consisting of notes to one of the beneficiaries and all of the trust corpus consisting of common stock to the other beneficiary. The trust instrument as well as local law was silent regarding whether the trustee had the authority to make such a non-pro rata distribution of property in kind. Because the trustee was not specifically authorized to make an allocation of specific property in kind, the beneficiaries were treated as having an absolute right to a ratable in kind distribution. Rev. Rul. 69-486 treated the beneficiaries as receiving the notes and common stock pro rata, followed by an exchange between the beneficiaries giving all of the common stock to one and all of the notes to the other. Since, in substance, an exchange between the beneficiaries was deemed to occur, Rev. Rul. 69-486 held that the beneficiaries recognized gain under §§ 1001 and 1002.

The division of Trust 2 is distinguishable from Rev. Rul. 69-486 because the trustees are authorized to make pro rata and non-pro rata distributions of trust property under the Trust instrument and under local law. Thus, the beneficiaries of the trust are not required to receive pro rata distributions for each asset of the trust. Because the trustees of the trust have the authority to make non-pro rata distributions based on fair market values, the proposed division of Trust 2 into separate trusts will not be treated as pro rata distributions followed by an exchange of assets among the beneficiaries of the trust with respect to the non-pro rata distribution of property interests. In this regard, see also Rev. Rul. 83-61, 1983-1 C.B. 78.

Rather than assessing tax liability on the basis of annual fluctuations in the value of a taxpayer's property, tax consequences of a gain or loss in property value are deferred until the taxpayer realizes the gain or loss. Eisner v. Macomber, 252 U.S. 189 (1920) (holding a pro rata stock dividend merely reflected the increased worth of the taxpayer's stock and the taxpayer realizes increased worth of property only by receiving something of exchangeable value proceeding from the property).

In Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), the Supreme Court addressed whether a sale or exchange has taken place that results in a realization of gain or loss under § 1001. The Court stated that an exchange of property gives rise to a realization event under § 1001(a) if the properties exchanged are materially different. Consequently, the Court held that an exchange of mortgages constituted a realization event under § 1001(a) because the exchanged interests - loans that were made to different obligors and secured by different homes - embodied legally distinct entitlements.

Under the proposed division of Trust 2, the provisions of each of the successor trusts would be identical to those of the original trust. The beneficiaries of each successor trust would have the same property interests and legal entitlements as they had under Trust 2. Accordingly, it is consistent with the holding in Cottage Savings to find that the beneficiaries' interests after the proposed distribution of Trust 2 corpus into successor trusts will not differ materially from the beneficiaries' interests under Trust 2. Thus, the division of Trust 2 into successor trusts will not be a sale, exchange, or other disposition of property of Trust 2 that gives rise to a realization of income to any beneficiary, Trust 2, or the successor trusts under § 1001.

Accordingly, based on the facts submitted and the representations made and assuming the transaction is carried out, and is effective, under State law, we conclude that the proposed division of Trust 2 will not constitute a sale or other taxable disposition of the assets of Trust 2 or of the successor trusts under § 1001.

Ruling Request #2:

Section 2501 imposes a tax on the transfer of property by gift by an individual. Section 2511 provides that the tax imposed by §2501 applies 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 shall be considered the amount of the gift. Section 2512(b) provides that where property is transferred for less than an adequate consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration is deemed a gift.

In this case, the dispositive provisions of the three successor trusts to Trust 2 will be identical to those of Trust 2, except that each of the three trusts will be established for the benefit of a single grandchild of Settlor. Based on the facts submitted and the representations made and assuming the transaction is carried out, and is effective, under State law, we conclude that the proposed pro rata division of Trust 2 will not result in a transfer by any of the beneficiaries of Trust 2 or of the three successor trusts that is subject to federal gift tax under § 2501.

Ruling Request #3:

Section 2601 imposes a tax on each generation-skipping transfer made by a transferor to a skip person.

Under § 1433(a) of the Tax Reform Act of 1986 (Act), the generation-skipping transfer tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to a transfer from a trust, if the trust was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date. Under § 26.2601-1(b)(1)(ii), any trust in existence on September 25, 1985, will be considered irrevocable unless the settlor had a power that would have caused inclusion of the trust in his or her gross estate under §§ 2038 or 2042, if the settlor had died on September 25, 1985.

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 will not cause the trust to lose its exempt status. The regulation provides that the rules contained in the paragraph 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 § 1001.

Section 26.2601-1(b)(4)(i)(D) provides that a modification 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. 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. 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.

Example 5, contained in § 26.2601-1(b)(4)(i)(E), 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 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 2 was irrevocable on September 25, 1985. It is represented that no additions, actual or constructive, were made to Trust 2 after that date.

The proposed division of Trust 2 into three separate trusts is substantially similar to the situation described in Example 5 of § 26.2601-1(b)(4)(i)(E). The proposed division will not result in a shift of any beneficial interest in the trust assets to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the reorganization. The three successor separate trusts must terminate on the same date that Trust 2 is required to terminate. Thus, the proposed division will not extend the time for vesting of any beneficial interest in the three successor separate trusts beyond the period provided for in Trust 2.

Accordingly, based on the facts submitted and the representations made and assuming the transaction is carried out, and is effective, under State law, we rule that, after the proposed division of Trust 2, the three successor trusts will be considered to have been created and to have become irrevocable before September 25, 1985, and will be exempt from generation-skipping transfer tax under chapter 13.

Ruling # 4:

Cottage Savings, supra, provides that a realization event occurs under §1001(a) when properties exchanged are materially different. Under the judicial confirmation in the Date 2 court order, there are no exchanges of the beneficial interests in the Trusts 1, 3, and 4. The judicial confirmation merely evidences the power granted to the trustee (and the legal entitlements of the beneficiaries) under the original trust agreement. Accordingly, based on the facts submitted and the representations made, we conclude that the judicial confirmation will not give rise to a realization event under § 1001.

This ruling does not address whether any actual or proposed division of Trusts 1, 3, and 4 will constitute a taxable disposition for purposes of § 1001.

Rulings # 5 & 6:

As discussed above, the judicial confirmation in the Date 3 court order of the corporate trustee's power to divide Trust 1, Trust 3, and Trust 4 (after the death of the son of Settlor for whom such trust is held) merely evidences the power granted to the trustee (and the legal entitlements of the beneficiaries) under the terms of Trust. The judicial confirmation does not cause any transfers to occur nor does it in any way alter the original provisions of Trust. Accordingly, based on the facts submitted and the representations made, we rule that the judicial confirmation of the corporate trustee's power to divide Trust 1, Trust 3, and Trust 4 (after the death of the son of Settlor for whom such trust is held) will not result in a transfer by any of the beneficiaries of those trusts that is subject to gift tax under § 2501. Further, after the issuance of the Date 3 court order containing the judicial confirmation, Trust 1, Trust 3, and Trust 4 continue to be exempt from generation-skipping transfer tax under chapter 13.

Except as specifically ruled herein, we express no opinion on the federal tax consequences of the modification under the cited provisions or under any other provisions of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,

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

Enclosure
Copy for section 6110 purposes

Cc: