Internal Revenue Service

Number: **200446020**
Release Date: 11/12/04
Index Number: 2601.03-01

Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
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Refer Reply To:
CC:PSI:B09 / PLR-155388-03
Date:
July 26, 2004

Legend

Original Trust =

Grantor =
Date 1 =
Wife =
Child =
Trust A =
Trust B =
State =
Court =

Dear :

This is in response to your letter, dated August 23, 2003, and prior correspondence requesting rulings regarding the income, estate, gift and generation-skipping transfer tax consequences of modifying Original Trust.

The facts submitted and the representations made are summarized as follows: Grantor created Original Trust, an irrevocable trust, on Date 1 to benefit Wife and Child. Date 1 is prior to September 25, 1985. No actual or constructive additions have been made to Original Trust after September 25, 1985.

Paragraph 2 of the Original Trust Agreement provides that the primary beneficiary of the trust is Wife and the secondary beneficiary is Child. During Grantor's life, all the income is distributed annually to Child. After Grantor's death, one half of the

income is paid to Wife and the balance is distributed in the trustees' discretion between Wife and Child. After Wife's death, all income is distributed annually among Child and Child's descendants in proportions as determined by the trustees in their discretion. If Child predeceases Child's spouse, the trustees have, in their sole discretion, the authority to distribute income to Child's spouse for her support, comfort, and maintenance until such time as she may remarry.

Paragraph 6 provides that the term of the trust shall be for the life of the survivor of nine named persons, including Grantor, all living on Date 1 (collectively "the measuring lives"). Paragraph 7 provides that upon the death of the survivor of the measuring lives, the remaining income and principal in the trust shall be distributed per stirpes to the surviving descendants of Child as provided in Paragraph 18. Child has the inter vivos power to appoint to any of Grantor's grandchildren in any year the sum of five thousand dollars or five percent of the principal of the trust, whichever is greater, but limited to a total amount thus distributed under the power of appointment to thirty-three and one-third percent of the original principal of the trust.

Paragraph 18 provides that in computing the distribution of the trust upon the death of the survivor of Grantor's children, all amounts distributed to any of Child's children through the exercise of the limited powers of appointment provided shall be considered as part of the trust property, and that the property distributed through a power of appointment shall be credited against the amount due to each of Child's children computed in paragraphs 18 and 19. Upon the death of the survivor of Grantor's children, the trust shall be divided subject to the provisions of paragraph 19 as follows: (a) if Child and his sibling each have the same number of surviving children, it shall be divided equally; (b) if one has one surviving child and the other has more than one surviving child, forty percent shall go to the child who has no siblings and sixty percent shall be divided equally between the children of the other. The descendants of a deceased child shall take the part of their deceased ancestor in both (a) and (b).

Paragraph 19 provides that Child shall have a testamentary power to appoint not more than two-thirds of the original principal of the trust during the lifetime of either of the child or children of Child or upon the death of the survivor of Child's children.

Of the nine measuring lives, only Grantor is deceased. Wife and Child are currently living.

The trustees propose to divide Original Trust into Trust A and Trust B in order to pursue different investment objectives based on the beneficiaries' needs. The division will be pursuant to State law. The Original Trust assets will be divided between Trust A and Trust B in a non-pro rata manner pursuant to an applicable State statue that allows a non-pro rata division of assets. Court has approved the proposed division of Original Trust and non-pro rata distribution of the Original Trust assets contingent upon receipt of a favorable private letter ruling from the Internal Revenue Service.

After the division, all of the income from Trust A shall be distributed to Wife. The term of Trust A shall be for Wife's life. Upon Wife's death, Trust A shall be merged into Trust B. Paragraph 18 and the second paragraph of paragraph 19 of the Original Trust agreement will not apply directly to Trust A since the term of Trust A will be for Wife's life.

Furthermore, the income of Trust B shall be distributed between Wife and Child in such amounts and upon such division as the trustees may deem necessary. The term of Trust B shall be the same as the term of Original Trust. Trust B will terminate under the same provisions as for the termination of Original Trust.

The trustees have requested the following rulings relating to the proposed division of Original Trust into Trust A and Trust B: (1) The proposed division will not cause Original Trust, Trust A, or Trust B, or any of their beneficiaries to recognize any gain or loss from the sale or other disposition of property under §§ 61 or 1001. (2) Pursuant to § 1015, the tax basis of the Trust A and Trust B in each property received in the proposed division will be the same as the tax basis of Original Trust in the property. (3) Pursuant to § 1223(2), the holding period of Trust A and Trust B in each property received in the proposed division will include the holding period of Original Trust in the property. (4) The proposed division will not cause the interest in any beneficiary of Original Trust, Trust A, or Trust B to be includible in the beneficiary's gross estate under §§ 2033, 2036, 2037, or 2038. (5) The proposed division will not cause any beneficiary of Original Trust, Trust A, or Trust B to have made a taxable gift for purposes of chapter 12. (6) After the proposed division, Original Trust, Trust A, or Trust B will each be treated as a trust that was irrevocable on September 25, 1985, for purposes of § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations; will remain exempt from the GST tax under § 2601; and will not result in an addition, actual or constructive, to the trusts. (7) Transfers from Original Trust to Trust A and Trust B and distributions from Trust A and Trust B (and from any successor trust) to their beneficiaries will not be GST transfers and will not be subject to the GST tax under § 2601.

Rulings 1, 2 and 3

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 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. Section 1001(c) provides that, except as otherwise provided, the entire amount of the gain or loss on the sale or exchange of property is recognized.

Section 1.1001-1(a) of the Income Tax Regulations provides, as a general rule, that 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 in either kind or in extent, is treated as income or as loss sustained.

For purposes of § 1001, in an exchange of property, each party to the exchange gives up a property interest in return for a new or additional property interest. Such an exchange of property is a disposition under § 1001(a). See § 1.1001-1.

Rev. Rul. 56-437, 1956-2 C.B. 507, holds 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 in order to extinguish their survivorship interests.

In Rev. Rul. 69-486, 1969-2 C.B. 159, 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 holds 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.

An exchange of property results in the realization of gain under § 1001 if the properties exchanged are materially different. Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991). A material difference exists when the exchanged properties embody legal entitlements "different in kind or extent" or if they confer "different rights and powers." Id. At 565.

The terms governing Trust A and Trust B will be consistent with the terms governing Original Trust. Upon the proposed division of Original Trust into Trust A and Trust B, each beneficiary will have the same right to income and principal collectively under Trust A and Trust B as the beneficiary had under Original Trust. The proposed division will not result in any change in the beneficial interests of any beneficiary.

The present case is distinguishable from Rev. Rul. 69-486 because state law authorizes the trustees of Original Trust to make a non-pro rata distribution based on fair market values. Thus, Trust A and Trust B are not required to receive pro rata distributions of each property held in Original Trust. The proposed division will not be treated as a pro rata distribution followed by an exchange of assets among the beneficiaries of Original Trust. The interests of the beneficiaries of Trust A and Trust B will not differ materially from their interests in Original Trust. The beneficiaries will hold essentially the same interests before and after the non-pro rata division. Accordingly, the proposed division will not cause Original Trust, Trust A, Trust B, or any of their beneficiaries to recognize any gain or loss from the sale or other disposition of property under §§ 61 or 1001.

Section 1015(b) provides that if property is acquired after December 31, 1920, by a transfer in trust (other than by 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 by 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 a 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 in 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 a 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 a 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 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 the taxpayer's hands as it would have in the hands of such other person.

Because § 1001 does not apply to the division of the trust assets, under § 1015 the basis of the trust assets will be the same after the partition as the basis of those assets before the partition. After the proposed division of Original Trust into Trust A and Trust B, the tax basis of Trust A and Trust B in each property received from Original Trust will be the same as the tax basis of Original Trust in such property. Accordingly, under § 1223(2) the holding period of Trust A and Trust B in each property received from Original Trust will include the holding period of Original Trust in such property.

Ruling 4

Section 2001 imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2033 provides that the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.

In this case, following the proposed division of Original Trust into Trust A and Trust B, the beneficiaries will have the same rights and interests in the Original Trust assets that they had before the division. Accordingly, we conclude that the proposed division of Original Trust into Trust A and Trust B will not cause the interest of any beneficiary of Original Trust, Trust A, or Trust B to be includible in the beneficiary's gross estate under § 2033.

Section 2036(a) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Section 2037(a) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, if (1) possession or enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent, and (2) the decedent has retained a reversionary interest in the property, and the value of such reversionary interest immediately before the death of the decedent exceeds five percent of the value of such property.

Section 2038(a)(1) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, revoke, or terminate, or where the decedent relinquished any such power during the 3-year period ending on the date of the decedent's death.

In order for §§ 2036-2038 to apply, the decedent must have made a transfer of property or any interest therein (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth) under which the decedent retained an interest in, or power over, the income or corpus of the transferred property. In the present case, the proposed division of Original Trust does not constitute a transfer within the meaning of §§ 2036-2038. The beneficiaries of the resulting trusts will have the same interest after the division as they had as beneficiaries before. We therefore conclude that the proposed division will not cause the interest of any beneficiary of Original Trust, Trust A, or Trust B to be includible in a beneficiary's gross estate under §§ 2036-2038.

Ruling 5

Section 2501(a) imposes a tax for each calendar year on the transfer of property by gift during the calendar year by any individual, resident or nonresident.

Section 2511(a) 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 the gift is made in property, the value thereof at the date of the gift is considered the amount of the gift.

Section 2512(b) provides that where property is transferred for less than an adequate and full 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 to be a gift, and is included in computing the amount of gifts made during the calendar year.

In this case, the beneficiaries of the resulting trusts will have the same interests after the proposed division that they had as beneficiaries under the original trust so there is no direct transfer of assets. Because the beneficial interests, rights, and expectancies of the beneficiaries are substantially similar, both before and after the proposed transaction, no transfer of property will be deemed to occur as a result of the division. Accordingly, we conclude that the division of Original Trust and the non-pro rata allocation of assets among Trust A and Trust B as proposed is not a transfer, direct or indirect, of property that will be subject to the gift tax imposed by § 2501.

Rulings 6 and 7

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

Section 2611(a) defines the term "generation-skipping transfer" to include a taxable distribution, 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), 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, but only to the extent that such transfer is 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)(ii)(A) provides that, except as provided in § 26.2601-1(b)(1)(ii)(B) or (C), any trust in existence on September 25, 1985, is considered an irrevocable trust except as provided in §§ 26.2601-1(b)(ii)(B) or (C), which relate to property includible in a grantor's gross estate under §§ 2038 and 2042. In the present case, Original 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) of this section) 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 in the original trust. Furthermore, 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 a shift in a beneficial interest in a trust.

In this case, Original Trust is a generation-skipping transfer trust because it provides for distributions to more than one generation of beneficiaries below the grantor's generation. Date 1 is prior to September 25, 1985, and Original Trust was irrevocable on September 25, 1985. Original Trust, therefore, is exempt from the generation-skipping transfer tax pursuant to § 26.2601-1(b)(1)(i).

The division of Original Trust proposed by the trustees is within the authority granted to them by state law. Because the terms of the resulting trusts will be the same as the terms of the original trust, the proposed division of the trust does not shift a beneficial interest 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. In addition, the proposed division does not extend the time for vesting of any beneficial interest in either trust beyond the period provided in the original trust. Based on the facts submitted and the representations made, we conclude that the proposed division of Original Trust will not affect Original Trust's status as exempt from the generation-skipping transfer tax. As a result, the proposed division will not cause distributions from or terminations of any interests in Original Trust, Trust A, or Trust B to be subject to the generation-skipping transfer tax.

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.

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.

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

Sincerely,

James F. Hogan
Senior Technician Reivewer, Branch 9
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosure
Copy of this Letter for § 6110 purposes