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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B04 – PLR-165079-04

Date: JUNE 02, 2005

In Re:

Legend:

Decedent =

Spouse =

Son =

Daughter 1 =

Grandson 1 =

Granddaughter =

Daughter 2 =

Grandson 2 =

Grandson 3 =

Daughter 3 =

Will =

Main Trust =

Court 1 =

Court 2 =

Daughter 3 Trust =

State =

Bank =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Year 1 =
Year 2 =
Date 8 =
Date 9 =

Dear _____ :

This is in response to a letter dated December 10, 2004, and other correspondence, requesting rulings regarding the income and generation-skipping transfer (GST) tax consequences of proposed modifications of to the Main Trust.

Facts

The facts submitted and representations made are as follows. Decedent died prior to September 25, 1985, survived by his spouse (Spouse), his son (Son), and three daughters, Daughter 1, Daughter 2, and Daughter 3. Daughter 2 subsequently died in Year 1, survived by two children, Grandson 2 and Grandson 3. Daughter 1 died in Year 2, survived by her two children, Grandson 1 and Granddaughter

Under Article Fifth of his Will, Decedent devised and bequeathed the residue of his estate in trust and directed the trustee to divide the property into Trust A and Trust B. Spouse was the lifetime beneficiary of both trusts and had a testamentary general power of appointment over the assets of Trust A. Spouse died prior to September 25, 1985, without exercising her general power of appointment. Under Decedent's Will, any assets in Trust A at Spouse's death passed to Trust B, hereinafter referred to as Main Trust.

Paragraph (4) of Article Fifth of Decedent's Will provides as follows:

(4) Upon the death of my wife, [Spouse], Trust B (and Trust A to the extent that my wife shall make no different disposition thereof) shall continue and the net income therefrom shall be paid to my daughters, [Daughter 1, Daughter 2, and Daughter 3], in equal shares, share and share alike, for their respective lifetimes. If one or more of my said daughters shall fail to survive me, the share such predeceased daughter would have received shall be paid to her surviving issue by right of representation.

Upon the death of the last surviving daughter, this trust shall terminate and the corpus together with accrued and undistributed income shall be

distributed to my grandchildren by right of representation, and including in this instance any lawful issue of my son, [Son].

Paragraph (5) of Article Fifth of Decedent's will (hereinafter referred to as the "income equalization provision") provides as follows:

If at any time after the death of my wife, [Spouse], and before the termination of my Trust Estate, the gross income from all sources in any one year of my son, [Son], shall be less than one-third (1/3) of the net income distributable under the Trust Estate during said year, the Trustee shall distribute to my said son an amount of money sufficient to make his annual gross income equal to the share received from my Trust Estate during such year by each of my daughters (or their issue by right of representation if one or more of them shall have died).

On Date 1, Court 1 issued a Decree of Final Distribution of Decedent's estate. The Decree was filed with Court 2 on Date 2.

On Date 3, Court 2 construed Paragraph (4) of Article Fifth of Decedent's will as follows:

Upon the death of either [Daughter 1, Daughter 2, or Daughter 3], the share of the net income that would have been received by that deceased daughter pursuant to Paragraph (4) of Article Fifth on page 8 of the Will of [Decedent] shall be paid to her surviving issue by right of representation. In the event such deceased daughter is not survived by any issue, the share of the net income that would have been received by the deceased daughter shall be distributed to the survivor(s) of [Daughter 1, Daughter 2, or Daughter 3].

In the same order, Court 2 construed Paragraph (5) of Article Fifth of Decedent's will (the "income equalization provision") as follows:

...(a) [Son's] right to receive a distribution from the Trust each year shall be determined on (1) the gross income of [Son] for the previous year; and (2) the net income distributable for the Trust for the current year; (b) if [Son's] gross income for the previous year is less than one-third (1/3) of the Trust's net income distributable for the current year, then [Son] shall be entitled to receive a distribution from the Trust in an amount equal to seventy-five percent (75%) of the difference between (1) the Trust's net income distributable for the current year; and (2) [Son's] gross income for the previous year; (c) Any distribution from the Trust to [Son] shall reduce the amount to be distributed by the Trust to [Daughter 1, Daughter 2, and Daughter 3], or their successors, on a pro rata basis.

On Date 4, upon Petition of Individual, as Trustee, for Instructions, Court 2 ordered that:

Trust income distributable to Son during the period January through April of each year shall be calculated ... based upon his gross income for the year which is 2 years before the current year. Thereafter his income distributions for the period May through December of each year will be adjusted to account for his actual gross income for the year before the current year.

On Date 5, Settlement Agreement was executed construing and modifying Main Trust in settlement of litigation that had been commenced regarding Main Trust. On Date 6, Court 2 approved the Settlement Agreement.

Under the terms of the Settlement Agreement and the First Amendment to the Settlement Agreement, one-fourth (1/4) of the assets held in Main Trust were transferred to a separate trust for the benefit of Daughter 3 and her issue ("Daughter 3 Trust".) Until the death of the last to die of Daughter 1 and Daughter 3 (Daughter 2 having died, survived by Grandson 2 and Grandson 3), the income of the Daughter 3 Trust will be distributed to Daughter 3 during her life and, after her death, will be distributed to the then-living issue of Daughter 3 by right of representation. Should Daughter 3 die without issue while Daughter 1 is still living, the trust income will be paid to Daughter 1 until her death. Upon the death of the last to die of Daughter 1 and Daughter 3, the Daughter 3 Trust will terminate and the corpus will be distributed outright to Daughter 3's then-living issue, or, if none, will augment, equally, the shares distributed from the Main Trust.

Regarding the assets that continued to be held in Main Trust, Main Trust income was divided into two equal shares. One share was payable to Daughter 1 for life and, at her death, to her then-living issue by right of representation. The other share was divided into two equal shares, one share for each of the two children of Daughter 2, Grandson 2 and Grandson 3. At the death of either child of Daughter 2, the deceased child's share will be paid to that child's then-living issue by right of representation. Should Daughter 1 die without issue while Daughter 3 is still living, Daughter 1's share of the trust income was to be paid to Daughter 3. Upon the death of the last to die of Daughter 1 and Daughter 3, the Main Trust will terminate and the corpus will be divided into three equal shares, Daughter 1's Share, Daughter 2's Share, and Son's Share. Daughter 1's Share and Daughter 2's Share will each be distributed to the respective Daughter's then-living issue, per stirpes or, if none, will augment, equally, the Daughter 3 Trust and the other shares being distributed from the Main Trust. Son's Share will be distributed to the then-living lawful issue of Son, per stirpes or, if none, will augment, equally, the Daughter 3 Trust and the other shares being distributed from the Main Trust.

In addition, under the Settlement Agreement and the First Amendment to the Settlement Agreement, the income equalization provision of Paragraph (5) of Article Fifth of Decedent's Will was modified to ensure that Son, Daughters 1 and 3 (or their issue), and the issue of Daughter 2 would receive the share of income each would have received under the original terms of the Main Trust. During Son's life, if, in any year before the termination of the Main Trust, Son's gross income from other sources for the year immediately preceding the current year is less than 1/2 of the Main Trust net income for the current year, the Trustee of the Main Trust will distribute to Son an amount of cash or other comparable liquid assets sufficient so that, when added to his gross income from other sources for the prior year, the sum thereof is equal to 1/3 of the sum of: (1) the Main Trust's net income for the current year; and (2) Son's gross income for the prior year. If during his life, Son receives any distributions from the Main Trust pursuant to the Income Equalization Provision, the Daughter 3 Trust will receive from the Main Trust an amount equal to 1/4 of Son's gross income from other sources. Starting at Son's death, if Daughter 3 is then still living, the Daughter 3 Trust will receive from the Main Trust a distribution in an amount equal to 1/9 of the Main Trust net income.

On Date 6, Court 2 issued an order instructing the Trustee that none of the Main Trust income was to be paid to Son's heirs during the period between Son's death and the termination of the Main Trust (on the death of the last to die of Daughter 1 or Daughter 3). On termination of the Main Trust, Son's share of the corpus of the Main trust is to be distributed to Son's issue, as described above.

On Date 7, the IRS issued a private letter ruling that the exempt status of the Main Trust for GST tax purposes would not be adversely affected by the modification of the Main Trust to establish the Daughter 3 Trust. In addition, the Daughter 3 Trust would also be exempt for GST tax purposes.

Currently, Bank is the trustee of the Main Trust. No assets have been directly or constructively added to the Main Trust (or the Daughter 3 Trust) since the death of Spouse before September 25, 1985.

Daughter 2's children, Grandson 2 and Grandson 3 are currently each receiving one-fourth of the income of the Main Trust, subject to the income equalization provision in favor of Son. Similarly, Daughter 1's children, Grandson 1 and Granddaughter are currently each receiving one-fourth of the income of the Main Trust, subject to the income equalization provision in favor of Son. Son and Daughter 3 are still living.

Grandson 1 desires that his interest in the Main Trust be severed and held as a separate trust. If the Main Trust terminated immediately, Grandson 1 would be entitled to receive one-sixth (1/6) of the Main Trust corpus. On Date 8, Agreement was executed by Grandson 1, Bank as trustee of the Main Trust, and by, or on behalf of, most individuals among the current and contingent beneficiaries of the Main Trust.

On Date 9, Court 2 issued an order approving the Agreement to modify and partition the Main Trust, subject to the issuance of a favorable private letter ruling from the IRS. The Agreement in its entirety is incorporated by reference into Court 2's order. Court 2's order approved the proposed language for the Grandson 1 Trust and the Main Trust as modified under the Agreement.

Pursuant to the Court 2 order, the Main Trust will be partitioned into two separate trusts, the Grandson 1 Trust and the Main Trust. The Grandson 1 Trust will consist of the assets held in the Grandson 1 Subaccount (discussed below) immediately before the partition, and the remaining assets in the Main Trust immediately before the partition will be held as the Main Trust.

Under the terms of the Court 2 order, until Daughter 3's death, the income of the Grandson 1 Trust will be distributed to Grandson 1 during his life and, at his death, will be distributed to the then-living issue of Grandson 1 by right of representation. The beneficiaries of the Grandson 1 Trust, acting by majority vote, may remove an acting trustee and may also appoint a trustee or co-trustees, if no trustee is then serving, who may be any person, or persons, other than a beneficiary, a beneficiary's spouse, or a person related or subordinate to a beneficiary within the meaning of § 672(c) of the Internal Revenue Code.

The income of the Daughter 3 Trust will continue to be distributed to Daughter 3 until her death.

Until Daughter 3's death, the "distributable income" of the Main Trust will be divided into three equal shares. One share will be paid to Granddaughter for life and, at her death, to her then-living issue by right of representation. One share will be paid to Grandson 2 for life and, at his death, to his then-living issue by right of representation. One share will be paid to Grandson 3 for life and, at his death, to his then-living issue by right of representation. The "distributable income" of the Main Trust is defined as the net income of the Main Trust reduced (as described below) by any payments of the Main Trust net income to Son during his life under the income equalization provision and payments of the Main Trust net income to the Grandson 1 Trust and the Daughter 3 Trust.

The Agreement modifies the income equalization provision of Paragraph (5) of Article Fifth of Decedent's Will. Under this modification, each year during Son's life, the Main Trust will distribute to the Grandson 1 Trust, the lesser of 1/8 of Son's outside gross income or 1/15 of the Main Trust net income; and to the Daughter 3 Trust, the lesser of 1/4 of Son's outside gross income or 2/15 of the Main Trust net income. Each year after Son's death, the Main Trust will distribute to the Grandson 1 Trust, 1/15 of the Main Trust net income; and to the Daughter 3 Trust, 2/15 of the Main Trust net income. During the life of Son, if, in any year prior to the termination of the Main Trust, Son's gross income from other sources for the year immediately preceding the current year is less than 8/15 of the Main Trust net income for the current year, the Trustee of the Main

Trust will distribute to Son an amount of cash or other comparable liquid assets sufficient so that, when added to his gross income from other sources for the prior year, the sum thereof is equal to $\frac{2}{5}$ of the sum of the Trust's net income for the current year plus Son's gross income for the prior year, minus the amounts distributed by the Main Trust to the Daughter 3 Trust and the Grandson 1 Trust.

Upon the death of Daughter 3, the Daughter 3 Trust, the Grandson 1 Trust, and the Main Trust will terminate. The Daughter 3 Trust will be distributed to Daughter 3's then-living issue, or, if none, will augment, proportionately, the shares distributed from the Main Trust. The Grandson 1 Trust will be distributed to Grandson 1 if he is then living, or, if not, to his then-living issue by right of representation or, if none, will augment, proportionately, the shares distributed from the Main Trust. The Main Trust will be divided into five equal shares, one share called the Daughter 1 Share; two shares collectively called the Daughter 2 Share; and two shares collectively called Son's Share. The Daughter 1 Share will be distributed to Granddaughter if she is then living, or, if not, to her then-living issue by right of representation or, if none, to the then-living issue of Daughter 1, or, if none, will augment, proportionately, the Daughter 3 Trust, the Grandson 1 Trust and the other shares being distributed from the Main Trust. The Daughter 2 Share will be divided into subshares by right of representation among, and will be distributed to, Daughter 2's then-living children and the then-living issue of a deceased child, or, if Daughter 2 has no then-living issue, will augment, proportionately, the Daughter 3 Trust, the Grandson 1 Trust and the other shares being distributed from the Main Trust. Son's Share will be distributed to the then-living lawful issue of Son, or, if none, will augment, proportionately, the Daughter 3 Trust, the Grandson 1 Trust and the other shares being distributed from the Main Trust.

Effective as of Date 8 and pending the Taxpayer's receipt of a favorable private letter ruling from the IRS and a Court 2 order approving the Agreement, the Grandson 1 Subaccount was established and funded with one-sixth of each asset of the Main Trust that could be divided, and an undivided $\frac{1}{6}$ interest in and to each asset that could not be divided.

As long as the Grandson 1 Subaccount is in existence, the Main Trust beneficiaries will have no current interest in the assets held in the Grandson 1 Subaccount or in the income, gains, expenses or losses attributable to such assets. The income from the assets held in the Grandson 1 Subaccount will be distributed solely to Grandson 1 and will not be considered in determining the income distributable to the Main Trust beneficiaries. None of the assets in the Grandson 1 Subaccount will be distributed to Son under to the Income Equalization Provision or the corresponding provision of the Main Trust in favor of Daughter 3.

As long as the Grandson 1 Subaccount is in existence, Grandson 1 will have no current interest in the assets of the Main Trust which are not held in the Grandson 1 Subaccount or in the income, gains, expenses, or losses attributable to such assets, except as follows:

(1) Each year during Son's life, the Trustee will allocate to the Grandson 1 Subaccount, from the assets of the Main Trust which are not held in the Grandson 1 Subaccount, an amount equal to the lesser of: (i) one-eighth (1/8) of Son's outside gross income for the prior year, or (ii) one-fifteenth (1/15) of the net income of the Main Trust.

(2) Upon Son's death if Daughter 3 is then living, and until the termination of the Main Trust, the Trustee will allocate to the Grandson 1 Subaccount an amount equal to 1/15 of all the Main Trust income distributions.

As long as the Grandson 1 Subaccount is in existence, the amount of the Main Trust income required to be distributed to Son under the Income Equalization Provision will be calculated as follows: If Son's outside gross income for the prior year is less than 8/15 of the income of the Main Trust, Son will receive that amount of income from the Main Trust necessary so that his total income, including his prior year outside gross income, will equal two-fifths (2/5) of the following: the income of the Main Trust plus Son's prior year outside gross income minus the amounts the Main Trust distributes to the Daughter 3 Trust and allocates to the Grandson 1 Subaccount.

As noted above, upon the receipt of a favorable ruling from the IRS and a final order from Court 2 approving the Agreement, the Grandson 1 Trust will be established and funded with the assets held in the Grandson 1 Subaccount.

The taxpayers have requested the following rulings:

1. The proposed division of the Main Trust into the Grandson 1 Trust and the Main Trust, will not cause the Main Trust or the Grandson 1 Trust to lose exempt status for generation-skipping transfer tax purposes, or otherwise be subject to Chapter 13.

2. The implementation of the proposed transaction to divide the Main Trust will not constitute a sale or exchange or other taxable disposition of assets under §§ 61 and 1001 by the Main Trust, the Grandson 1 Trust, or any beneficiary thereof.

Ruling Request #1:

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, 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 Tax Reform 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 generally applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. Unless noted otherwise, 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.

Rev. Rul. 95-58, 1995-2 C.B. 191 concludes that a settlor's retained power to remove a trustee and appoint an individual or corporate trustee or successor that is not related or subordinate to the settlor (within the meaning of § 672(c)), will not be considered retention of the trustee's discretionary powers for purposes of §§ 2036 and 2038.

In the present case, the Main Trust was irrevocable on September 25, 1985, and the Daughter 3 Trust is deemed to have been irrevocable as of that date. It is represented that no additions, actual or constructive, were made to the Main Trust and the Daughter 3 Trust after September 25, 1985.

The proposed division of the Main Trust into the Grandson 1 Trust and the Main Trust is substantially similar to the situation described in Example 5 of § 26.2601-1(b)(4)(i)(E). Under the proposed modification and division, the Grandson 1 Trust and the Main Trust will, except as discussed below, be administered under the original terms of the Main Trust as provided in Decedent's will, as construed and modified by the orders of Court 2 on Date 3 and Date 9.

The modifications governing income payments to the Grandson 1 Trust, the Daughter 3 Trust, and to the Main Trust beneficiaries are intended to ensure that the beneficiaries will receive the same shares of income they would have received under the original terms of the Main Trust as construed by Court 2 on Date 3. Similarly, the modification to the income equalization provision is intended to ensure that the beneficiaries receive the same shares of income they would have received under the terms of the Main Trust as construed by Court 2 on Date 3 and Date 4. Further, under the proposed modification and division, the Grandson 1 Trust, the Daughter 3 Trust, and the Main Trust will terminate at the same time as provided under the original terms of Main Trust.

Under Court 2's Date 9 order, the beneficiaries of the Grandson 1 Trust are granted a power, that is not contained in the Main Trust instrument, to remove and replace trustees (or co-trustees). The trustees appointed pursuant to this replacement power cannot be a beneficiary of the Grandson 1 Trust, the spouse of such beneficiary, or subordinate or related to such beneficiary within the meaning of § 672(c). Thus, the removal and replacement power satisfies the standards contained in Rev. Rul. 95-58, and therefore, the possession of the power would not generally subject the trust corpus to inclusion in the possessor's gross estate.

Consequently, we conclude that the division of the Main Trust into the Grandson 1 Trust and the Main Trust, and the modifications as described above, will not result in a shift of any beneficial interest in trust assets to any beneficiary who occupies a

generation lower than the persons holding the beneficial interests prior to the partition and modification. In addition, the modification and division will not extend the time for vesting of any beneficial interest in the Grandson 1 Trust, the Daughter 3 Trust, and the Main Trust beyond the period provided for under the original terms of the Main Trust.

The provisions governing income payments under the Grandson 1 Subaccount are identical to those governing income payments under the Grandson 1 Trust; and the subaccount and the Grandson 1 Trust are subject to the identical modified income equalization provision. Further, the Grandson 1 Subaccount will be transferred to the Grandson 1 Trust on receipt of the favorable private letter ruling. Thus, as discussed above, the temporary allocation of the assets of the Main Trust to the Grandson 1 Subaccount, will not result in a shift of any beneficial interest in trust assets to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the establishment of the subaccount. Further, the allocation of assets of the Main Trust to the Grandson 1 Subaccount will not extend the time for vesting of any beneficial interest in the Grandson 1 Subaccount, the Daughter 3 Trust, and the Main Trust beyond the period provided for under the original terms of the Main Trust.

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 the Main Trust into the Grandson 1 Trust and the Main Trust, will not cause the Main Trust or the Grandson 1 Trust to lose exempt status for generation-skipping transfer tax purposes, or otherwise be subject to Chapter 13.

Ruling Request #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 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 § 1011 for determining loss over the amount realized.

Section 1001(b) states 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 (other than money) received. Under § 1001(c), except as otherwise provided in subtitle A, the entire amount of gain or loss, determined under § 1001 of the Code, 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 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 of the transaction. 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 §§ 1001 and 1002.

In Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), the Court considered whether a sale or exchange that has taken place results in the realization of gain or loss under § 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 Court concluded that § 1.1001-1 reasonably interprets § 1001(a) and therefore, an exchange of property gives rise to a realization event under § 1001(a) if the properties exchanged are "materially different." 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" 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. Therefore, the taxpayer realized losses when it exchanged interests in the loans. Cottage Savings, 499 U.S. at 566.

In the present case, under the proposed division that was approved by the appropriate state court, Grandson 1's interest will be severed from the Main Trust to pursue a different investment policy. However, the beneficiaries' interests in the Main Trust and the Daughter 3 Trust will not change in kind or extent and no interests will be created. All of the provisions of the Main Trust will remain unchanged. Thus, consistent with the Court's opinion in Cottage Savings, the interests of the beneficiaries of the Main Trust, Daughter 3 Trust, and the Grandson 1 Trust will not differ materially from their current interests in the Main Trust and Daughter 3 Trust. In addition, the present case is distinguishable from the facts of Rev. Rul. 69-486 because the State Probate Code authorizes the trustee to make non-pro rata distributions. Accordingly, we conclude that the proposed transaction will not result in a material difference in kind or extent of the legal entitlements enjoyed by the beneficiaries, and no gain or loss is recognized by the beneficiaries or the trusts on the division for purposes of § 1001.

Except as specifically ruled herein, we express no opinion on the federal tax consequences of the proposed modifications 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,

George Masnik
Chief, Branch 4
Office of Associate Chief Counsel
(Passthroughs and Special
Industries)

Enclosure

Copy for section 6110 purposes