Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:4- -PLR- 139635-01
Date:
March 07, 2002

Re:

LEGEND:

Trustor =

Son =

Daughter =

E =

F =

G =

H & I =

J & K =

L, M, & N =

Trust =

Trustee =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

State Statute =

Dear :

This is in response to your letter dated February 8, 2002, and previous correspondence requesting a ruling concerning the income, gift, and generation-skipping transfer tax consequences of the proposed severance of Trust under §§ 1001, 2501, and 2601 of the Internal Revenue Code.

The facts and representations submitted are summarized as follows: Trust was created on Date 1 by Trustor, for the benefit of his children and their issue. Trust was amended and restated on Date 2. Trustee, a national banking association, is the trustee of Trust. Trustor died on Date 3, survived by his two children, Son and Daughter. Son died on Date 4, and Daughter died on Date 5. Daughter was survived by three children, E, F, and G, all of whom were living upon the date of Trustor's death. Currently, E, F, and G are the primary beneficiaries of Trust.

The pertinent provisions of Trust are summarized as follows:

Under Article I of Trust, Trustor may, only if he first secures the written consent of Trustee, revoke the Trust agreement in whole or in part, amend it from time to time, and may withdraw principal from Trust.

Article II of Trust provides that during the life of Trustor, Trustee is to pay so much of the net income of Trust property to Trustor as he shall direct in writing. If Trustor becomes incompacitated, in the opinion of Trustee, in consultation with Trustor's children, Trustee is to pay to Trustor so much of the net income and any portion of the principal for the support, comfort and welfare of Trustor in his accustomed manner of living, or for any purpose Trustee believes to be in Trustor's best interests. Any income that is not distributed is to be added to principal.

Article III provides that after Trustor's death, Trustee is to divide the Trust property into separate trusts, equal in value, one for each then living child of Trustor, and one for the living descendants, collectively, of each deceased child of Trustor. With respect to each trust set aside for a living child of Trustor, Trustee is to pay all the net income of each separate child's trust in convenient installments, at least quarterly for so long as the respective child shall live. In addition, during the lifetime of Trustor's daughter, Daughter, Trustee may pay to or use for the benefit of one or more of Daughter's descendants so much or all of the income from Daughter's trust (and so much of the income of her brother's (Son's) trust, should Son predecease Daughter leaving no descendants surviving Son) as Trustee determines to be required, in addition to their income from all other sources known to Trustee, for the reasonable support, comfort, and education of Daughter's descendants so long as Trustee does not deprive Daughter of any Trust income which is required by Daughter for her

reasonable support and comfort.

If Trustee determines that the income available from all sources known to Trustee is insufficient for a child's reasonable support, comfort, and welfare and that of the rest of such child's immediate family, Trustee may pay so much of the principal of the child's trust as Trustee determines to be required to such child.

Upon the death of any surviving child of Trustor, Trustee is to hold the deceased child's separate trust as follows: Trustee is to pay all the net income of each separate trust to the descendants of the deceased child, per stirpes, or if there are no descendants of the deceased child, then to Trustor's descendants, per stirpes, in convenient installments, at least quarterly, until 21 years after the death of the last survivor of Trustor's descendants living at the date Trustor's death, whereupon the Trustee is to distribute the entire trust property to the descendants of the deceased child of Trustor, per stirpes, or if there are no descendants of the deceased child, to the Trustor's descendants, per stirpes, whereupon the deceased child's trust will terminate.

With respect to each trust which has been set aside for the living descendants collectively of a deceased child of Trustor, the trustee is to pay all of the net income to the descendants, per stirpes, of the deceased child in convenient monthly installments at least quarterly until twenty-one (21) years after the death of the last survivor of Trustor's descendants living at the date of Trustor's death. At that time, the Trustee is to distribute the entire Trust property, to the descendants of the deceased child of Trustor, per stirpes, or if there are no such descendants, then to the descendants of Trustor, per stirpes, with due allowance and adjustment for advances of principal.

Advances of principal may be made to any child of a deceased child of Trustor, if the Trustee determines that the income of any child of a deceased child of Trustor is not sufficient for such child's reasonable support, comfort and welfare, and that of his or her immediate family.

Article IV(7) provides that if at any time a trust created under Trust, after having been commingled with any similar trust for the beneficiary or beneficiaries thereof, has an aggregate principal amount of $10,000 or less, the Trustee may terminate the trust and distribute the assets thereof to the beneficiary or beneficiaries, at that time, or the current trust income, or if there are more than one beneficiary in the proportions in which they are beneficiaries.

It is represented that there is no significant disharmony between E, F, and G. E has two children, H and I; F has two children, J and K; and G has three children, L, M, and N. E, F, and G live in different regional areas of the United States. E, F, and G have determined that each would prefer to have Trust divided into three separate and equal fractional interest trusts with substantially similar terms as Trust. In addition, upon the death of any of E, F, and G, it is proposed that each deceased child's share will be divided into separate subtrusts, per stirpes, one for each descendant of the deceased child of Trustor, or if there are none, then per stirpes, for the then living

descendants of the nearest ancestor of the current income beneficiary who is a descendant of Trustor, and who has one or more descendants then living, or if also none, then per stirpes for the then living descendants of Trustor. Each share created for a descendant of Trustor for whom a separate trust has previously been created under Trust is to be added to that separate trust.

Under the proposed trust terms for the trusts that are to be created as a result of the partition of Trust and the future division of the three trusts upon the death of each respective child of Trustor the Trustee is to pay all of the income of each separate trust to the current income beneficiary of the trust, in convenient installments, at least quarterly. In addition, the Trustee may, if the Trustee determines that the income of a current beneficiary, from all sources known to the Trustee is not sufficient for his or her comfort, support, education, and general welfare or for the reasonable comfort, support, education, and general welfare of his or her minor children, pay to the current income beneficiary, or use for his or her benefit so much or all of the principal of the separate trust as the Trustee determines for those purposes.

Upon the partition of Trust into three equal trusts the trusts (and the creation of any future subtrusts) each trust and subtrust will terminate twenty-one years after the death of the last to die of all beneficiaries living on the date of death of Trustor's death. The assets of each separate trust and subtrust that is created from Trust will then be distributed outright to the current income beneficiary if living, or if deceased, to the current income beneficiary's then living descendants, per stirpes.

The proposed terms of the newly created trusts will provide that whenever any separate subtrust of a current income beneficiary shall be less than $25,000, the Trustee may, in its discretion pay out and distribute the separate trust to the beneficiary where upon the trust will terminate as the beneficiary thereof.

It is represented that each and every asset of Trust will be allocated on a pro rata basis to the three fractional interest trusts (and the further division of the trusts into subtrusts upon the death of a child of Daughter) upon the division of Trust. If an asset of Trust cannot be evenly divided, it will be sold and the proceeds divided evenly among the newly created trusts.

It is represented that Trust's terms which provide for per stirpes distributions of income to the beneficiaries establishes that each of the three current beneficiaries (E, F, and G) has a vested interest in one-third of the income produced by the trust's assets, and each of the three beneficiaries has no interest in the other two-thirds of the income generated by Trust.

It is represented that upon receipt of a favorable ruling from the Internal Revenue Service, the Trustee will petition the appropriate State court seeking an order authorizing the partition of Trust into three equal separate trusts (and the further division of the trusts into subtrusts upon the death of a child of Daughter), as more fully described above.

The following rulings are requested:

1. Neither the partition of Trust nor the distributions of the assets to the three partitioned trusts on an equal fractional share basis as proposed will result in the realization of gain or loss under section 1001.

2. The proposed reformation and division of Trust into three separate and equal trusts, and the subsequent division of a trust when the current income beneficiary of the trust dies will not constitute an addition to Trust or a modification of Trust or of any of the three partitioned trusts that would cause Trust or any partitioned trust to lose its exempt status under section 1433(b)(2)(A) of the Tax Reform Act of 1986, provided that there are no additions to Trust or to the partitioned trusts after September 25, 1985.

3. Neither the partition of Trust nor the distributions of the assets to the three equal fractional interest trusts as proposed, will cause a taxable gift, under section 2501, to be made by any beneficiary of Trust.

LAW AND ANALYSIS

Ruling 1. Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in section 1011 for determining loss over the amount realized.

Section 1.1001-1(a) of the Income Tax Regulations provides that except as otherwise provided in subtitle A of the Code, the gain or loss realized from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

A partition of jointly owned property is not a sale or other disposition of property where the co-owners of the joint property sever their joint interests, but do not acquire a new or additional interest as a result thereof. Thus, neither gain nor loss is realized on a partition. See Rev. Rul. 56-437, 1956-2 C.B. 507.

In Rev. Rul. 69-486, 1969-2 C.B. 159, distinguished by, Rev. Rul. 83-61, 1983-1 C.B. 78, a non-pro rata distribution of trust property was made in kind by the trustee, although the trust instrument and local law did not convey authority to the trustee to make a non-pro rata distribution of property in kind. The distribution was effected as a result of a mutual agreement between the trustee and the beneficiaries. Because neither the trust instrument nor local law conveyed authority to the trustee to make a non-pro rata distribution, Rev. Rul. 69-486 held that the transaction was equivalent to a pro rata distribution followed by an exchange between the beneficiaries and was subject to the provisions of sections 1001 and 1002.

The present case is distinguishable from Rev. Rul. 69-486 because the assets of Trust will be divided and allocated pro rata between the three fractional interest trusts. Accordingly, the proposed transaction will not be treated as a pro rata distribution followed by an exchange of assets among the beneficiaries of the original Trust.

Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991) concerns the issue of when a sale or exchange has taken place that results in realization of gain or loss under section 1001. In Cottage Savings, a financial institution exchanged its interests in one group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans. The two groups of mortgages were considered "substantially identical" by the agency that regulated the financial institution.

The Supreme Court in Cottage Savings, 499 U.S. at 560-61, concluded that section 1.1001-1 of the regulations reasonably interprets section 1001(a) and stated that an exchange of property gives rise to a realization event under section 1001(a) if the properties exchanged are "materially different."

In defining what constitutes a "material difference" for purposes of section 1001(a), the Court stated that properties are "different" in the sense that is "material" to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent. Cottage Savings, 499 U.S. at 564-65. The Court held that mortgage loans made to different obligors and secured by different homes did embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans.

It is consistent with the Supreme Court's opinion in Cottage Savings to find that the interests of the beneficiaries of Trust, in the three equal fractional interest trusts, (and the interests of the beneficiaries upon the future pro rata division of the partitioned trusts into subtrusts) will not differ materially from their interests in the original Trust. The proposed transaction will not change the interests of the beneficiaries. Instead, the beneficiaries will be entitled to the same benefits after the proposed transaction as before. The transaction here is similar to the kinds of transactions discussed in Rev. Rul. 56-437, since the Trust here is to be divided, but all other provisions of the Trust will remain unchanged, other than changes described above. Thus, the proposed transaction will not result in a material difference in the kind or extent of the legal entitlements enjoyed by the beneficiaries. Accordingly, the conclusion that the proposed division will not result in a material change is unaffected by the fact that it is anticipated that after the division, the trustee of the three equal fractional interest trusts may cause the partitioned trusts to invest in dissimilar assets.

Therefore, the division of the Trust into three equal fractional interest trusts, and the pro rata allocation of each existing asset into the three trusts (and the future division of the three trusts into subtrusts with a pro rata allocation of each asset into such subtrusts) will not result in the realization of any gain or loss under section 1001 by the Trust, the subtrusts, or any of the beneficiaries.

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

Section 1433(b)(2)(A) of the Tax Reform Act of 1986 (the Act), 1986-3 (Vol. 1) C.B. 1, and section 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, provide that the generation-skipping transfer tax shall not apply to any generation-skipping transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer was not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added).

Section 26.2601-1(b)(1)(iv) provides rules that if an addition is made after September 25, 1985, to an irrevocable trust which is excluded from the application of chapter 13 by reason of section 26.2601-1(b)(1), a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the provisions of chapter 13.

Section 26.2601-1(b)(4) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax under section 26.2601-1(b)(1), (b)(2), or (b)(3), will not cause the trust to lose its exempt status. The rules of section 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. They do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of section 1001.

Section 26.2601-1(b)(4)(i)(D) provides that a modification of the governing instrument of an exempt trust by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, but only if—(1) The modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and (2) The modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. A modification of an exempt trust will result in a shift in a beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a generation-skipping transfer or the creation of a new generation-skipping transfer.

Section 26.2601-1(b)(4)(I)(E), Example 5, illustrates a situation where a trust that is otherwise exempt from the GST tax is divided into two trusts. Under the facts presented, the division of the trust into two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interests prior to the division, and the division does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Accordingly, the two partitioned

trusts will not be subject to the provisions of chapter 13.

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

Based on the facts presented and the representations made, the division of Trust into three equal fractional interest trusts, one for the benefit of each of E, F, and G, and their respective minor children (and the subsequent division of a fractional interest trust upon the death the primary beneficiary of that trust) will not result in a shift of any beneficial interest in Trust to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the division. Further, the proposed division will not extend the time for vesting of any beneficial interest in the new trusts beyond the period provided for under the original Trust.

We conclude that the proposed transaction will not constitute an addition to Trust or a modification of Trust or of any of the three partitioned trusts that would cause Trust or any partitioned trusts to lose its exempt status under § 1433(b)(2)(A) of the Tax Reform Act of 1986, provided that there are no additions to Trust or to the partitioned trusts after September 25, 1985.

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

Section 2511(a) provides that subject to the limitations contained in the gift tax chapter, the gift tax imposed by section 2501 will apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift will be considered the amount of the gift. Section 2512(b) states that where property is transferred for less than adequate and full consideration in money or money's worth, the amount by which the value of the property exceeds the value of the consideration received shall be deemed a gift.

The division of Trust assets between the three fractional interest trusts and the further division of the trusts as proposed will not result in any change in the beneficial interests of any of the Trust beneficiaries. Accordingly, based on the facts submitted and representations made, the division of Trust into three equal fractional interest trusts and their further division into subtrusts, will not cause any beneficiary of Trust or any of the any of the proposed trusts that will be established upon the death of a child of Trustor, to have made a taxable gift for federal gift tax purposes under section 2501.

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

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

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by the appropriate party. While this office has not verified any part of the material submitted in support of the request for rulings, it is subject to verification and examination.

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

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

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

Enclosure
Copy of letter for section 6110 purposes
cc: