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Department of the Treasury

P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:4 - PLR-111171-02
Date: DECEMBER 16, 2002

Re:

Legend:

Trust 1 =

Trust 2 =

Husband =
Wife =
Husband's Trust Agreement =

Wife's Trust Agreement =

Son 1 =
Son 1's Spouse =
Son 1's Daughter =
Son 1's Son =
Son 2 =
Daughter =
Foundation =
Bank =
Individual =
Year 1 =

Year 2 =
Year 3 =
Date 1 =
Agreement =
Trust Indenture for Family of Son 1's Daughter =

Trust Indenture for Family of Son 1's Son =

State =
Corporation =
Successor Corporation =

Dear :

This is in response to a letter dated February 14, 2002, and subsequent correspondence, requesting rulings regarding the income, gift and generation-skipping transfer (GST) tax consequences of the proposed merger of two trusts and the subsequent division of the resulting trust.

Facts

The facts submitted and representations made are as follows. In 1954, Husband executed an irrevocable trust agreement (Husband's Trust Agreement) creating four separate trusts: one for the benefit of Foundation, and one for each of his children, Son 1, Son 2, and Daughter, and their families. On the same date, Wife executed a substantially identical irrevocable trust agreement (Wife's Trust Agreement) creating four trusts for the benefit of the same three individuals and Foundation.

Trust 1 was established under Husband's Trust Agreement, and Trust 2 was established under Wife's Trust Agreement. Both trusts were established for the benefit of Son 1, Son 1's Spouse, Son 1's Daughter, Son 1's Son, any afterborn children of Son 1, Son 1's grandchildren and their issue. Trusts 1 and 2 are the subjects of this ruling request.

The terms of Trust 1 and Trust 2 as provided under Husband's Trust Agreement and Wife's Trust Agreement, respectively, are substantially identical. The net income of each trust may be distributed to any of the beneficiaries, at any time, and in any amounts as the corporate trustee determines in it's discretion, taking into account the circumstances of the beneficiaries and all other income and benefits each is receiving from all sources known to the corporate trustee. If at any time before each trust terminates none of the individuals for whose benefit it was established are then

living, the corpus and accumulated income will be divided equally among, and distributed to, the trusts provided under the trust agreement for Son 2 and Daughter and their families. If there are no family trusts then existing, then until final distribution, the income of each trust must be distributed to the trust for Foundation.

The trustees may distribute principal for the "proper support, comfort, education, maintenance or assistance" of any beneficiary entitled to receive income from each trust or "to enable any such beneficiary to meet any accident, emergency or misfortune." No individual trustee can participate in any decision to make these discretionary principal distributions. A discretionary principal distribution to an income beneficiary will be treated as an advancement and will be charged against the share of that beneficiary or that beneficiary's descendants when the trust terminates.

Trusts 1 and 2 must terminate no later than the date twenty-one (21) years after the death of the last survivor of a group consisting of the settlor (Husband or Wife, respectively), Son 1, Son 1's Spouse, Son 1's Daughter, Son 1's Son, Son 2, Son 2's spouse, Son 2's daughter and son, and Daughter and her spouse. Upon the termination of Trusts 1 and 2, the assets of each trust will be distributed outright to Son 1's then living descendants, per stirpes. Husband's Trust Agreement and Wife's Trust Agreement provide that, if upon final termination of the trusts for the families of Son 1, Son 2, and Daughter, there are no then living descendants of Son 1,Son 2, and Daughter, the assets of Trusts 1 and 2 (and of the trusts for Son 2's family and Daughter's family) will be distributed outright to Foundation, or if it is not then a charity, to a charity selected by the trustees.

The terms of Trust 1 and Trust 2 require that each trust have three individuals and one corporation serving as trustees at all times. The initial individual trustees may appoint their own successors. Successor individual trustees must be appointed by the remaining individual trustees, or if none, by a majority of the income beneficiaries. All individual trustees may remove and replace a corporate trustee. Any domestic corporation that is a bank or trust company with capital and surplus of at least $2 million is qualified to serve as a corporate trustee. Bank, Son 1's Daughter, Son 1's Son, and Individual are currently serving as the trustees of both Trust 1 and Trust 2.

Husband and Wife both died before September 25, 1985. Daughter died in Year 1 (prior to September 25, 1985) with no surviving spouse or descendants. The trusts for her family were divided between the trusts for Son 1's family and the trusts for Son 2's family created under Husband's and Wife's Trust Agreements. Son 2 died in Year 2 survived by two children who now have their own children. Son 1 died in Year 3, survived by his spouse and his two children who now have children.

The current beneficiaries of Trusts 1 and 2 are Son 1's Spouse, Son 1's Son and his four adult children and 10 minor grandchildren, and Son 1's Daughter and her two adult children and one minor grandchild.

No additions, actual or constructive, were made to Trusts 1 and 2 after September 25, 1985. It is represented that approximately twenty-five years ago, Trusts 1 and 2 made distributions of stock over several years. One-half of each distribution was paid in equal shares to the children of Son 1's Son and the other one-half of each distribution was paid to the children of Son 1's Daughter in equal shares. No other distributions have been made from Trusts 1 and 2.

Son 1's Daughter and Son 1's Son have different investment philosophies. This has led the current trustees of Trusts 1 and 2 to implement a reorganization of Trusts 1 and 2.

On Date 1, the current trustees of Trusts 1 and 2 and all of the adult beneficiaries of Trusts 1 and 2 executed Agreement. Agreement provides that, subject to the receipt of a favorable ruling from the Internal Revenue Service, Trusts 1 and 2 will be merged and simultaneously divided equally into two separate trusts, one trust for the benefit of Son 1's Spouse, Son 1's Daughter, and her family (New Trust for Family of Son 1's Daughter), and the other trust for the benefit of Son 1's Spouse, Son 1's Son, and his family (New Trust for Family of Son 1's Son) referred to under Agreement as the "New Trusts." It is represented that to implement Agreement, the trustees will merge all of the assets of Trusts 1 and 2 and immediately divide them pro rata between the two New Trusts. In addition, Agreement amends the provisions of Trusts 1 and 2 and provides that the New Trusts will have the same provisions as Trusts 1 and 2, as amended under Agreement.

On Date 1, the current trustees of Trusts 1 and 2 and all of the adult beneficiaries of Trusts 1 and 2 also executed Trust Indenture for Family of Son 1's Daughter and Trust Indenture for Family of Son 1's Son. Each of these trust indentures contains provisions identical to those of Trusts 1 and 2 as amended under Agreement.

The provisions of New Trusts differ from those of Trusts 1 and 2 as follows:

The New Trusts must each have one corporate trustee, and no fewer than two and no more than four individual trustees. A corporate trustee of a New Trust will not be related or subordinate, within the meaning of § 672(c), to any of the beneficiaries of the trust. Any domestic corporation that is a bank or trust company with capital and surplus in excess of $2 million is qualified to serve as a corporate trustee. Initially, the trustees of the New Trust for Family of Son 1's Daughter will be Bank, Son 1's Daughter, and her spouse. The trustees of the New Trust for Family of Son 1's Son will be Bank, Son 1's Son, and his spouse. The initial individual trustees of the New Trusts may appoint their own successors.

In addition to the broad investment powers the trustees have under Trusts 1 and 2, the New Trusts authorize the trustees to select any investments of their choice including a list of specified investments.

Trusts 1 and 2 provide that all stock in Corporation must be voted exclusively by the individual trustees. The New Trusts provide that only the individual trustees are entitled to vote any securities of the successor to Corporation, Successor Corporation, and any successor corporations held by the New Trusts.

If at any time during its term, a New Trust has no then living beneficiaries, the assets of that trust will be distributed to the other New Trust, if then existing, and if not then existing, in equal parts to the trusts for Son 2's family, if then existing. If the trusts for Son 2's family are not then existing, then until final distribution, the income of the New Trust will be distributed to the trust for Foundation; however, instead, the trustees, in their discretion, may decide to distribute all of the assets of the New Trust outright to a charity they select.

Under the provisions of Trusts 1 and 2, the trustees are authorized to appoint investment advisors but are not relieved of responsibility for following the advisors' advice. The provisions of the New Trusts hold the trustees harmless for following any advice of an investment advisor.

It is represented that under State law, the trustees and adult beneficiaries of Trusts 1 and 2 may effect the merger, simultaneous division, and amendment of Trusts 1 and 2 by executing Agreement in lieu of obtaining a court order.

We have been asked to rule as follows:

1. The merger of Trusts 1 and 2 into a single trust and the division of that trust into New Trusts will not constitute a sale or other taxable disposition of assets of Trusts 1 and 2 under § 1001 of the Code.

2. The merger of Trusts 1 and 2 into a single trust and the division of that trust into New Trusts will not result in a transfer by any of the beneficiaries that is subject to gift tax under § 2501.

3. After the merger of Trusts 1 and 2 into a single trust and the division of that trust into New Trusts, each of the New 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 Request #1:

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

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

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss is the excess of the adjusted basis provided in § 1011 over the amount realized. Under § 1001(c), except as otherwise provided in Subtitle A, the entire amount of gain or loss determined under § 1011 on the sale or exchange of property is recognized. Section 1001-1(a) provides that except as otherwise provided in subtitle A of the Code, 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.

In Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991), the issue was whether a financial institution realized tax deductible losses when it exchanged 90 percent participation interests in one group of residential mortgages for another lender's 90 percent participation interests in a different group of residential mortgages. The Supreme Court of the United States reasoned that because the participation agreements exchanged derived from loans made by different obligors and were secured by different homes, the interests exchanged embodied legally distinct entitlements and hence were materially different. Therefore, the Court held that the taxpayer sustained tax deductible losses. Unlike the facts presented in Cottage Savings, the facts presented here involve a merger of Trusts 1 and 2 and the simultaneous pro rata division of trust assets into two New Trusts under state law.

Rev. Rul. 56-437, 1956-2 C.B. 507, concludes that a severance by partition of jointly owned property is not a sale or other disposition if there is no new or additional interest acquired as a result of the severance. Similar to the situation outlined in the revenue ruling, no new or additional interest is created as a result of the proposed transaction.

Based on the information submitted and the representations made and assuming the transaction is carried out, and is effective, under State law, we conclude that the merger of Trusts 1 and 2 into one resulting trust, and the simultaneous pro rata division of the trust assets into the New Trusts, is not a sale or other disposition under § 1001. The trustees and beneficiaries will hold the same bundle of rights before and after the proposed reorganization.

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 terms of Trust 1 and Trust 2 are identical. Each distribution made from Trust 1 and from Trust 2 was divided equally among the children of Son 1's Son and the children of Son 1's Daughter. The dispositive provisions of the New Trusts will be identical to those of Trust 1 and Trust 2 (except as noted above) except that each New Trust will be established for the benefit of a single family. 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 merger of Trusts 1 and 2 into a single trust and simultaneous pro rata division of that trust's assets into New Trusts will not result in a transfer by any of the beneficiaries 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, 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 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 principalis 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.

Example 6 contained in § 26.2601-1(b)(4)(i)(E), considers a situation where, in 1980, Grantor established an irrevocable trust for Grantor's child and the child's issue. In 1983, Grantor's spouse also established a separate irrevocable trust for the benefit of the same child and issue. The terms of the spouse's trust and Grantor's trust are identical. In 2002, the appropriate local court approved the merger of the two trusts into

one trust to save administrative costs and enhance the management of the investments. The merger of the 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 merger. In addition, the merger 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 trust that resulted from the merger will not be subject to the provisions of chapter 13.

In the present case, Trusts 1 and 2 were irrevocable on September 25, 1985. It is represented that no additions, actual or constructive, were made to Trusts 1 and 2 after that date.

The merger of Trusts 1 and 2 into a single trust is substantially similar to the situation described in Example 6 of § 26.2601-1(b)(4)(i)(E). The simultaneous division of the resulting single trust into the two New Trusts is substantially similar to the situation described in Example 5 of § 26.2601-1(b)(4)(i)(E). The merger of Trusts 1 and 2 and the division of the merged trusts into New Trusts 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. New Trusts must terminate on the same date that Trusts 1 and 2 were required to terminate. Thus, the merger and division will not extend the time for vesting of any beneficial interest in the New Trusts beyond the period provided for in Trusts 1 and 2.

The modifications to New Trusts regarding the number of individual trustees, the nature of the corporate trustees, the appointment of successor individual trustees, the liability of the trustees and their investment powers, and the reference to Successor Corporation, are administrative in nature. The modifications granting the trustees discretion to alter the timing and the beneficiary of charitable distributions will not result in any shift in the beneficial interests in trust to lower generation beneficaries.

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 merger of Trusts 1 and 2 into a single trust and the division of that trust into New Trusts, each of the New 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.

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,

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

Enclosure
Copy for section 6110 purposes