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Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B04
PLR-104917-05

Date: JANUARY 19, 2006

In Re:

LEGEND:

Grantor	=
Trust	=
County Court	=
Date 1	=
Date 2	=
Date 3	=
Son 1	=
Son 2	=
Daughter 1	=
Daughter 2	=
Construction Agreement	=

Dear :

This is in response to your January 20, 2005 letter and other correspondence requesting a ruling concerning the income and gift tax consequences of the settlement agreement as it relates to the trust.

You have requested the following rulings:

1. The execution of the Construction Agreement, the Court's approval of the Construction Agreement, the Trustee's creation of the Daughters' Trust pursuant to the authority provided in the Trust, and the Trustee's subsequent distribution of assets to the Daughters' Trust in accordance with the Construction Agreement

do not result in a sale or exchange, or other disposition, of any property by any of the children of Grantor, or the Trust, or the recognition of any gain or loss with respect to any Trust assets;

2. The execution of the Construction Agreement, the Court's approval of the Construction Agreement, the Trustee's creation of the Daughters' Trust pursuant to the authority provided in the Trust, and the Trustee's subsequent distribution of assets to the Daughters' Trust in accordance with the Construction Agreement do not cause the Daughters' Trust to receive more than its pro-rata share of the distributable net income of the Trust through the date of funding; and
3. The execution of the Construction Agreement, the Court's approval of the Construction Agreement, the Trustee's creation of the Daughters' Trust pursuant to the authority provided in the Trust, and the Trustee's subsequent distribution of assets to the Daughters' Trust in accordance with the Construction Agreement do not constitute, or result in, a taxable gift by the children of Grantor, or the Trustee, pursuant to section 2501.

The facts submitted are as follows:

On Date 1, Grantor created Trust. Article II provides that Trust is irrevocable.

Article 3.01.A defines "Trustor's Children" as Son 1 and Son 2. Article 3.01.B provides that the trustee may distribute to Trustor's Children and their descendants so much net income and principal as will provide for the beneficiaries' health, education, maintenance, and support. Additionally, the trustee is to have the power to distribute to "Trustor's children" so much net income and principal as the trustee may determine to be appropriate to assist in any business or investment venture. Article 3.01.C provides that Trust will terminate on the first to occur of (1) the second anniversary of Grantor's death, or (2) the death of the last survivor of Trustor's Children and their descendants. Upon termination, the Trust assets will be administered in accordance with Articles 3.02 and 3.03.

Article 3.02 provides, in relevant part, that the trustee is to divide Trust into separate equal shares, one share for each then living Child and one share for the then living descendants, collectively, of each deceased Child.

Grantor's two daughters, Daughter 1 and Daughter 2, alleged that the term "Trustor's children" included them, and thus, they were eligible for distributions to assist them with business and investment ventures. Questions also arose as to whether children born or adopted by Grantor after the Trust's creation would be eligible for distributions. On Date 2, the trustee petitioned County Court to construe and interpret several provisions of the Trust. The County Court determined that any children born after the Trust's creation were not beneficiaries of the Trust. In order to settle the remaining disputes, the children entered into a Construction Agreement. The trustee

represents that the Construction Agreement's interpretation of the ambiguities are consistent with the County Court's earlier order on children born after Trust's creation.

The terms of the Construction Agreement call for the daughters as well as the sons to be eligible for Trust distributions to assist in any business or investment venture. The Construction Agreement also stipulates that the maximum distribution to the daughters under the Trust would be 50 percent of the value of Trust on the date of the distribution. In order to prevent any future disagreements over distributions, the Construction Agreement calls for the trustee to distribute 50 percent of the assets, on an in-kind pro rata basis, to a new trust for the benefit of the daughters. The new trust will have provisions substantially similar to the original Trust. Once the new trust for the benefit of the daughters has been created, no further distributions will be made from the original Trust for their benefit, except in the event of the death of one of the Sons (or a descendant of one of the Sons) where that person is not survived by a descendant. Likewise, no distributions from the Daughters' Trust would be made to the Sons or any descendants of a Son except in the event of the death of one of the Daughters (or a descendant of one of the Daughters) where that person is not survived by a descendant. On Date 3, County Court approved the Construction Agreement.

LAW AND ANALYSIS

Ruling 1

Section 61(a)(3) provides that gross income includes gains derived from dealings in property and, under section 61(a)(15), from an interest in a trust.

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

Section 1001(b) provides that the amount realized from the sale or other disposition of property is the sum of any money received plus the fair market value of the property (other than money) received. Under section 1001(c), except as otherwise provided in subtitle A, the entire amount of gain or loss, determined under section 1001, on the sale or exchange of property is 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 into 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 if 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.

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 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 of the United States in Cottage Savings, 499 U.S. at 560-61, concluded that section 1.1001-1 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. Cottage Savings, 499 U.S. at 566.

It is consistent with the Supreme Court’s opinion in Cottage Savings to find that the interests of the beneficiaries after the division will not differ materially from the interests in the original Trust. In accordance with the Construction Agreement, the Trust will be divided on a pro rata basis. Except for the changes described above, all other provisions of Trust will remain unchanged. Accordingly, the proposed transaction will not result in a material difference in kind or extent of the legal entitlements enjoyed by the beneficiaries. Therefore, based on the facts presented and the representations made, we conclude that the transaction will not result in a sale or exchange, or other disposition, of any property, and no gain or loss is recognized by the children of Grantor or the trusts on the division for purposes of section 1001(a).

Ruling 2

Section 643(a) provides that the term “distributable net income” means, with respect to any taxable year, the taxable income of the estate or trust computed with certain modifications.

Section 661(a) provides that in any taxable year there shall be allowed as a deduction in computing the taxable income of an estate or trust (other than a trust to which subpart B applies), the sum of (1) any amount of income for such taxable year required to be distributed currently (including any amount required to be distributed which may be paid out of income or corpus to the extent such amount is paid out of income for such taxable year); and (2) any other amounts properly paid or credited or

required to be distributed for such taxable year, but such deduction is not to exceed the distributable net income of the estate or trust.

Section 662(a) provides generally that there is to be included in the gross income of a beneficiary to whom an amount specified in section 661(a) is paid, credited, or required to be distributed the sum of the following amounts: (1) the amount of income for the taxable year required to be distributed currently to such beneficiary, whether distributed or not; and (2) all other amounts properly paid, credited, or required to be distributed to such beneficiary for the taxable year. Section 662(a), however, limits the amount of trust distributions included in the gross income of a beneficiary to the distributable net income of the trust.

Section 663(c) provides for the sole purpose of determining the amount of distributable net income in the application of sections 661 and 662, in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries in the trust are to be treated as separate trusts.

Section 1.663(c)-2(a) provides that a separate share comes into existence upon the earliest moment that a fiduciary may reasonably determine, based upon the known facts, that a separate economic interest exists.

Section 1.663(c)-2(b)(1) provides that the amount of distributable net income for any share under section 663(c) is computed as if each share constituted a separate trust or estate. Accordingly, each separate share is to calculate its distributable net income based upon its portion of gross income that is includible in distributable net income and its portion of any applicable deductions or losses.

Section 1.663(c)-2(c) provides that for purposes of calculating distributable net income for each separate share, the fiduciary must use a reasonable and equitable method to make the allocations, calculations, and valuations required by section 1.663(c)-2(b).

In this case, the Trustee will distribute 50 percent of the assets to Daughters' Trust on a pro rata basis. Therefore, based on the facts presented and the representations made, we conclude that the distribution will not cause the Daughters' Trust to receive more than its allocable share of the distributable net income of the Trust through the date of funding.

Ruling 3

Section 2501 imposes a tax for each calendar year on the transfer of property by gift during such calendar year by any individual.

Section 2511(a) provides that, subject to certain limitations, the gift tax applies whether the transfer is in trust or otherwise, direct or indirect, and whether the property

transferred 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), provides, in part, that where property is transferred for less than 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 shall be deemed a gift.

In Commissioner v. Estate of Bosch, 387 U.S. 456 (1967), the Supreme Court considered whether a state trial court's characterization of property rights conclusively binds a federal court or agency in a federal estate tax controversy. The Court concluded that the decision of a trial court as to an underlying issue of state law should not be controlling when applied to a federal statute. Rather, the highest court of the state is the best authority on the underlying substantive rule of state law to be applied in the federal matter. If there is a decision by that court, then the federal authority must apply what it finds to be state law after giving "proper regard" to the state trial court's determination and to relevant rulings of other courts of the state. In this respect, the federal agency may be said, in effect, to be sitting as a state court.

In this case, the Construction Agreement represents a mutual understanding that clarifies and defines the interests that each of the beneficiaries received from Grantor at the time that Grantor created Trust. State Court's construction of Trust is consistent with applicable state law that would be applied by the highest court of the state. Accordingly, based on the facts submitted and representations made, we conclude that the execution of the Construction Agreement, the Court's approval of the Construction Agreement, the Trustee's creation of the Daughters' Trust pursuant to the authority provided in the Trust, and the Trustee's subsequent distribution of assets to the Daughters' Trust in accordance with the Construction Agreement do not constitute, or result in, a taxable gift by the children of Grantor, or the Trustee, pursuant to section 2501.

In accordance with the Power of Attorney on file with this office, copies of this letter are being sent to your authorized representatives.

Except as expressly provided herein, no opinion is expressed or implied concerning the 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) of provides that it may not be used or cited as precedent.

Sincerely yours,

Katherine Mellody
Senior Technician Reviewer, Branch 4
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure:

Copy of letter for section 6110 purposes