

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Legend

Trust C =
Trust D =
Trust A =
Trust B =
State =
Court =
Year 1 =
Year 2 =
Year 3 =
A =
B =
C =
D =
E =
F =
G =
H =
J =
K =

Dear

This is in response to the private letter ruling request dated June 20, 2000, that you submitted on behalf of the trustees of Trust D. We have received additional submissions from you dated October 19, 2000, November 15, 2000, December 8, 2000, and January 26, 2001.

ISSUE

You requested a ruling as to whether the proposed reformation of the income interests in Trust C and Trust D will result in the realization of gain or loss under § 1001 of the Internal Revenue Code.

CONCLUSION

The proposed reformation of the income interests in Trust C and Trust D will not result in the realization of gain or loss under § 1001.

FACTS

Trust C and Trust D each has as its principal investment activity the ownership and rental of farmland in State. Each trust is irrevocable and is classified as a simple trust.

The parties involved with Trust C and Trust D are as follows: C and D (the "Sons") are the only children of A and B. C and D are both adults. D has two children, E and F, both adults. E has two children, G and H, both minors. C has two children J and K, both adults. A and B are both deceased.

in Year 1 while residents of State, A and B desired to establish separate trusts for each of their Sons (and their families). To accomplish this objective, A and B executed two irrevocable trust agreements in Year 1. The terms of the two trusts were identical except that each trust was primarily for the benefit of one Son and the family of that Son. The corpus of each trust consisted of an 80 acre parcel of State farm land. The 80 acre parcels were of substantially equal value. One of the trusts was denominated as Trust A for income Tax purposes. The other trust was denominated as Trust B for income tax purposes.

In Year 2, A and B again intended to establish new trusts of equal value for each Son (and his family). To carry out this purpose, they executed the two irrevocable trust agreements which are the subject of this ruling request. The trust agreement between A, the trustor and B, the trustee, has always been denominated as Trust C for income tax purposes. The trust agreement between B, as trustor, and A, as trustee, has always been denominated as Trust D for income tax purposes.

The situs of Trust C and Trust D is State due to the fact that the assets of each trust consist only of farm real estate located in State (and a very small amount of cash), and each trust expressly provides that all questions of law shall be determined in accordance with the laws of State.

By a decree of the Court in Year 3, C is the trustee of Trust C, and D is the trustee of Trust D. A and B were still alive at the time of this decree. This decree added a provision to Trust D stating,

In the event the Trustee shall die, resign or become incapacitated during the term of the Trust, [D] shall be the successor Trustee, without bond. In the event that [D] dies, becomes incompetent to serve or ceases to serve for any reason, [C] shall serve as successor Trustee, without bond. If [C] does not serve or ceases to serve for any reason, the last Trustee to serve shall designate his

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successor as Trustee. Every successor Trustee shall have the same duties and powers as are assumed and conferred in this agreement upon the Trustee, including the duty to appoint his successor as Trustee.

The same decree added a similar provision to Trust C naming C as the successor Trustee, and providing for D to serve as Trustee if C does not serve.

The terms of the two trusts are similar in that each trust is primarily for the benefit of the family of one Son, however, the income interest in each trust is shared between the two Sons. The corpus of each trust consisted of an 80 acre parcel of State farm land owned by the respective trustor and no additional assets have been transferred to either of the trusts. At the present time, each trust owns an 80 acre parcel of farm land in State and the value of the parcels is substantially equal and any difference in fair market value can be considered de minimis.

At the time Trust C and Trust D were created and funded, it was the intention of the respective trustors, to establish separate trusts of equal value for each of their sons. Although the 80 acre tracts of farm land were equivalent in value, the tract used to fund Trust C was subject to a mortgage debt, while the tract used to fund Trust D was owned free of any indebtedness. The method chosen to equalize the two trusts was to divide the income interest in each trust between the two sons, so the income to each son (or his family) would reflect the reduction in income caused by the mortgage payment. In due course, the mortgage was paid in full, and both trusts are now free of indebtedness. The purpose of the provisions to share the income of the two trusts between the two current income beneficiaries has been accomplished. However, contrary to the intentions of the trustors, the draftsman omitted any provision to terminate the shared income interests after the mortgage indebtedness was fully paid.

Article II of the trust agreement provides,

After payment of the charges and expenses of the trust, the trustee shall pay to the trustor's sons, C and D, in equal shares, all of the current net income in convenient installments at least annually. After the death of either of said sons, one-half of the current net income shall be paid to the children of said deceased son, in equal shares subject to Article III C.

Article III provides that at the death of the surviving Son of B, the trustee shall divide the trust assets so as to provide one share for each living child of D and one share collectively for the living children of each deceased child of D. Article III paragraph A provides that:

Shares for each living child of D shall remain in trust until his youngest living child attains age twenty-one (21). During such period of time the income and principal of each of said shares shall be fully available for the care, support, maintenance and education of said living child of D....

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Article III paragraph C provides:

If at any time any share becomes distributable to a beneficiary who has not attained the age of twenty-one (21) years, then and in each such case, the trustee shall retain possession of such share for the period during which that beneficiary is under the age of twenty-one (21) years, and in the meantime the trustee shall use and expend so much of the income and principal of such share as he in his sole discretion deems necessary or advisable for the care, support, maintenance and education of that beneficiary, and any income not so expended shall be added to principal. When the beneficiary attains the age of twenty-one (21) years, any balance held for his or her benefit shall be paid over and distributed outright to him or her. If a beneficiary for whom such a share is held shall die before attaining the age of twenty-one (21) years, then any remaining portion of his or her share shall be paid over and distributed outright to his or her heirs; provided, however, that any portion otherwise distributable to an heir of said beneficiary for whom a share of the trust is then being held pursuant to this instrument be paid over to the Trustee of such and become a part thereof.

PROPOSED TRANSACTION

The trustees have filed an action in the Court requesting that the Court approve an amendment to each trust that removes one son as an income beneficiary from one trust and makes him the sole current income beneficiary of the trust under which his family receives the remainder interest. Each of the children of the respective Sons, presently being all of the living remaindermen, has joined in this legal action by filing a Consent and Waiver.

The Trustees will request that the Court construe the trusts in light of the intent and purposes of the trustors and make certain amendments to the trusts.

To fully implement the intention of the trustors to have separate trusts for each son (and his family), the Court will be requested to amend each trust to remove one son as an income beneficiary from one trust and make him the sole current income beneficiary of the trust under which his family receives the remainder interest. In other words, the Court will be requested to remove D as an income beneficiary of Trust C and remove C as an income beneficiary of Trust D.

Each of the original trusts provides that only after the death of both Sons, will the trusts terminate and the assets be distributed to the descendants of the Son named in the particular trust. In order not to accelerate the termination of the trusts, which might occur depending on the order of the death of the Sons, the amendments to the trusts retain the requirement that both Sons must die before ultimate distribution of the assets of the trust.

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The Trustees have proposed to the Court that Trust D be amended by deleting Article II of the original trust agreement and substituting in lieu thereof:

ARTICLE II

After payment of the charges and expenses of the trust, the trustee shall pay to the trustor's son, [D], all of the current net income in convenient installments, at least annually, during his lifetime. Upon the death of trustor's son, [D], if the trustor's other son, [C], survives, then in such event said income shall be paid to the children of [D], in equal shares subject to Article III C.

The trustees have proposed to the Court to make a similar amendment to Trust C.

As part of the amendments, the Trustees have also requested that the Court reform the successor trustee provisions to provide that the adult children of each Son serve as successor co-trustees of their family's trust rather than the other Son.

To implement this change, the Trustees have proposed to the Court that Trust D be amended by deleting the provision dealing with trustee succession and substituting in lieu thereof the following new Article X:

At this time [D] is the trustee of this trust. In the event [D] shall cease for any reason to serve during the term of this Trust, [E] and [F], shall serve as successor co-trustees. If either of them does not serve or ceases to serve for any reason, the other shall continue to serve as sole trustee. If both [E] and [F] do not serve or ceases to serve for any reason, the last trustee to serve shall designate his or her successor as Trustee. Every successor trustee shall have the same duties and powers as are assumed and conferred by this agreement upon the Trustee, including the duty to appoint his successor as Trustee.

The Trustees have proposed to the Court that a similar amendment be made to Trust C that names J and K as successor trustees.

LAW AND ANALYSIS

Section 61(a)(3) of the Internal Revenue Code provides that gross income includes gains derived from dealings in property.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in § 1011 for determining gain, and the loss is the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized. Under § 1001(c), the entire amount of gain or loss must be recognized, except as otherwise provided.

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

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property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), concerns when a sale or exchange has taken place that results in 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 Supreme Court in Cottage Savings, 499 U.S. at 560-61, concluded that § 1.1001-1 of the regulations reasonably interprets § 1001(a) and stated that an exchange of property is 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" to the Code so long as they embody 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. Id., at 566.

The Court, in Cottage Savings, rejected the Service's argument that properties are "materially different" only if they differ in economic substance. Id., at 562. The Service argued unsuccessfully that differences in properties are material for purposes of the Code only when it can be said that the parties, the relevant market, and the relevant regulatory body would consider them material. Id., at 565.

The taxpayer has represented that removing D as an income beneficiary of Trust C and removing C as an income beneficiary of Trust D would carry out the original intentions of the trustor. If the Court determines that this is the case and orders that D be removed as an income beneficiary of Trust C and orders that C be removed as an income beneficiary of Trust D as a way to meet the original intentions of the trustors of the two trusts, this will not result in a sale or disposition for purposes of § 1001 of the Code. The proposed transaction will not be an exchange between the income beneficiaries of Trust C and Trust D, but instead will be a clarification of the original intention of the trustor. Therefore it is consistent with § 1001 and Cottage Savings to conclude that the proposed removal of income beneficiaries from Trust C and Trust D will not constitute a sale or disposition under § 1001.

Further, the modification of the manner in which the successor trustees will be named is not a material difference for purposes of § 1001 or Cottage Savings. This will be a change in the way that Trust C and Trust D will be administered and this change will be consistent with the intention to have a separate trust for each Son and his family. Since E, F, J, and K are adults, the trustee would not have any discretion over payments to

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them. This means that, if E, F, J, or K were to become a trustee of Trust C or Trust D, they would not have discretion over payments to themselves. In the event that a minor were to become an income beneficiary of the trust, the revised trust agreement would not require that the income beneficiary also be the trustee.

No opinion is expressed about the federal income tax treatment of the transaction under other provisions of the Code.

The above rulings are directed only to the taxpayer who requested them. Section 6110(k)(3) of the Code provides that these rulings may not be used or cited as precedent.

Sincerely,
Associate Chief Counsel
(Income Tax & Accounting)
By: Michael D. Finley
Chief, Branch 3

Enclosure:

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