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Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:04 – PLR-154296-03

Date:
March 25, 2004

Re:

Legend:

Trust =

Trustee =
D =
E =
F =
G =
H =
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D Group =

E Group =

F Group =

Dear ,

This is in response to your submission dated September 3, 2003, concerning the income, gift, estate and generation-skipping transfer (GST) tax consequences of a proposed division of Trust.

According to the facts submitted, Trust was created on Date 1 by Q and R (husband and wife), for the primary benefit of their grandchildren and the grandchildren's issue. Q and R have three children, D, E, and F. D's children are G, H, and I and with their children, are referred to as the "D group". E's children are J, K, L, and M, and with their children are referred to as the "E group." F's children are N, O, and P, and with their children are referred to as the "F group." Q and R are both deceased.

The pertinent terms of Trust provide as follows:

Section II of Trust provides that the Trustee is to divide Trust into three equal shares. Each share is to be set aside for the issue, per stirpes, of D, E, and F, respectively, and administered as a separate trust. Each child of Q and R for whose issue a share is set aside is to be referred to as a "primary descendant."

Trustee is to distribute the income of each separate trust at least annually to or among the issue of the primary descendant and such issue's lineal descendants. After the death of the primary descendant and all of his or her lineal descendants, the income of the separate trust is to be distributed among Trustors' lineal descendants in such proportions as determined by Trustee in its sole discretion.

In lieu of the distribution of income as provided, Trustee has the power to accumulate any portion or all of the income of the separate trust only if Trustee has satisfied itself that such accumulations of income will be in the best interests of the issue of the primary descendant and such issue's lineal descendants, and after Trustee

has given full consideration to the throwback rules contained in section 669 of the Internal Revenue Code (as then in effect).

Trustee may in its discretion, at any time, distribute any part or all of the principal of the separate trust to or among the issue of the primary descendant and such issue's lineal descendants, and upon the death of such issue and their lineal descendants to or among Q and R's lineal descendants.

Section III provides that each separate trust created under Trust, unless sooner terminated, is to end immediately prior to the expiration of twenty-one years from and after the death of the last survivor of Q and R, and the issue of Q and R's parents living on Date 1. Thereupon, Trustee is to distribute the principal of each trust free of trust, in equal proportions to the person or persons then entitled to receive the net income or if there is no person or persons then entitled to receive the net income, to Q and R's heirs. Subsection D of section I provides that a distribution that is to be made to a person's heirs is to be made to and among the persons who would have been entitled to that person's personal property, and in the proportions to which they would have been entitled, if such person, being then domiciled in State, had died intestate with respect thereto immediately following the date specified for distribution.

Under Section IV, the Trustee in its sole discretion is authorized to distribute income and/or principal to a beneficiary of a separate trust who has not attained the age of 21 years. Under Section IV(A)(1), income may be distributed to the beneficiary himself or herself or to his or her guardian or applied for the beneficiary's support, maintenance, education, benefit and/or recreation of the beneficiary and his or her dependents, in such manner as Trustee deems to be in the best interest of the beneficiary and his or her dependents. Trustee may accumulate the balance of any such income and/or principal not so applied, and hold the income in further trust as a separate trust for the benefit of the beneficiary.

Under Section IV(B) during the continuance of any trust created under the Trust instrument, if Trustee, in its sole discretion, determines that the funds payable to or for the benefit of any beneficiary of a trust, together with the funds available to the beneficiary from other sources are insufficient to provide properly for the essential needs such as food, clothing, education, shelter and illness expenses of the beneficiary and his or her dependents, Trustee is authorized to pay the beneficiary any part or the whole of any trust from which the beneficiary may then be receiving payments.

Section IV(D) provides that the interest of any beneficiary in either the income or principal of a separate trust is not to be alienated or in any other manner assigned or transferred by the beneficiary. Such interest is to be exempt from execution, attachment, distress for rent, and other legal or equitable process which may be instituted by or on behalf of any creditor or assignee of the beneficiary.

Section V(B) authorizes the Trustees to make any distribution or division, whether income or principal, wholly or partially in kind, without allocating the same kind of property to different distributees. The provision also authorizes the Trustees to distribute undivided interests in any asset.

Under Section VI(A), Q and R and/or any other person may add to the trust fund or to any share or portion at any time. Section VI(B) provides that Trust is irrevocable and under no circumstances may any of the portion of the principal or income of Trust revert to Q and R or their estates. Under section VI(C), the number of individual trustees may be increased (not to exceed three) or decreased at any time by a majority of the trustees. In the case of a vacancy, the person to fill the vacancy is to be selected by the remaining trustees, or if only one remains, by that one. Except for D, Q and R's lineal descendents are not eligible to be selected as individual trustees.

It is represented that the corpus of Trust has been managed and invested as one trust and distributions of income have been made in equal shares to the D, E, and F groups.

The information submitted states that in , Trustee received a letter from K's counsel threatening to bring a lawsuit that would seek to have Trust declared not one trust but three separate trusts. In addition, K's counsel stated that the lawsuit would seek damages for mismanagement, breach of fiduciary duties and other alleged wrongs with respect to Trust.

On Date 2, Trustee filed an action for declaratory judgment in Court, seeking a declaration that Trustees were not obligated under the terms of Trust, either at its inception or at the time of the declaratory judgment action, to divide Trust into three trusts, one for the benefit of each of the three groups. On Date 3, E Group filed a counterclaim against Trustees and others, alleging breach of fiduciary duty and mismanagement of Trust. In the course of the litigation E Group also alleged misconduct on the part of Company that is wholly owned by Trust, for misconduct or mismanagement related to the management of the Company's property.

On Date 4, Court entered an Order that the trust instrument created one trust, to be administered as three separate and independent shares. Thereafter, the focal point of the litigation became the counterclaims asserted by the E Group. After considerable discovery and preparations for trial on the counterclaims, the parties were directed by the Court to mediate the issues involved in the litigation. A mediation was held in and resulted in the Settlement Agreement. On Date 5, the Court entered an Order approving the Settlement Agreement.

The Settlement Agreement provides, in part, that Trust will be divided into three separate trusts, one trust for the benefit of D Group, one trust for the benefit of E Group, and one trust for the benefit of F Group. The Settlement Agreement also provides that new trust instruments are not required to be created for the separate trusts. Rather, the Settlement Agreement provides that the trusts are to be the same in form and terms as Trust, except that whenever Trust refers to beneficiaries, each reference shall mean solely the beneficiaries in the family line for whom the separate trust is established. The beneficiaries of each of the three separate trusts will have the same rights and obligations as the beneficiaries under Trust, including the right to select trustees of their respective trusts strictly in accordance with the terms of Trust.

A large portion of the assets owned by Trust consist of approximately X acres of timberlands located in State. The timberlands owned by Trust are managed by Company, a corporation whose stock is wholly owned by the Trust. Other assets owned by Trust include a diversified portfolio of cash and marketable securities and a limited partnership interest. The Settlement Agreement provides that all three of the separate trusts will receive equal shares of the timberlands. The D Group trust and the F Group trust will each be allocated Y% of the Company stock and debt and the E Group trust will be allocated cash or marketable securities in the amount equal to the value of Y% of the Company stock and debt. All other assets of Trust will be valued by appropriate appraisers who will equitably divide Trust's assets into three separate shares for each of the separate trusts.

The Settlement Agreement is conditioned upon a favorable ruling from the IRS. The rulings requested are as follows:

1. The proposed modification and division of Trust into three separate and equal trusts, the non-pro rata transfer of assets from the original Trust to each separate trust, and the possible change of trustees with respect to any such separate trust will not constitute an addition to or a modification of Trust (or any of the three separate trusts) that would cause Trust or any separate trust to lose, wholly or partially, its exempt status under section 2601, or section 1433(b)(2)(A) of the Tax Reform Act of 1986, and will not subject distributions from any of the trusts to the generation-skipping transfer tax under chapter 13 of the Code, so long as there are no additions to the Code.

2. The proposed non-pro rata distribution of the assets of Trust to three separate trusts on an equal basis as proposed will not result in the realization of gain or loss to Trust or to any separate trust or beneficiary thereof under section 61 or section 1001.

3. The proposed division of Trust and non-pro rata distribution of assets into three separate trusts will not result in a transfer subject to gift tax under section 2501 by Trust or by the any of Trust's beneficiaries.

4. The basis of each asset received by each separate trust from Trust will be the same as the basis which that asset maintained when held by the original Trust pursuant to section 1015.

5. The holding period for each asset received by each separate trust from the original Trust will include the same holding period for that asset as held by the original Trust according to section 1223(2).

6. Each of the three separate trusts will constitute a separate trust for purposes of section 643, and for purposes of determining the application of any generation-skipping transfer tax subsequent to the division of Trust.

Ruling 1. 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, 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 the three separate trusts as described above, 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 division of Trust into the D Group Trust, the E Group Trust, and the F Group Trust will not cause Trust or any partitioned trusts to lose exempt status under section 1433(b)(2)(A) of the Tax Reform Act of 1986.

Ruling 2. Section 61(a)(3) of the 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 property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

Rev. Rul. 56-437, 1956-2 C.B. 507, provides that 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.

In Rev. Rul. 69-486, 1969-2 C.B. 159, 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 a 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, an exchange that required recognition of gain under § 1001.

Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991), provides that an exchange of property results in the realization of gain or loss under §1001 if the properties exchanged are materially different. Properties exchanged are materially different if the properties embody legal entitlements "different in kind or extent" or if the properties confer "different rights and powers." Id. at 565. In Cottage Savings, the Court held that mortgage loans made 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. 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 their respective possessors enjoy legal entitlements that are different in kind or extent. Id. at 564-65.

In the present case, the beneficiaries are severing their interests under the original Trust. However, because the original trust authorizes non-pro rata partitions, the proposed trust partition into three new trusts with substantially identical terms and provisions will not result in the beneficiaries acquiring any new or additional interests. Therefore, the partition of the original trust is not a sale or other disposition of property, under Rev. Proc. 56-437, and does not result in a material difference in the legal entitlements enjoyed by the beneficiaries under Cottage Savings. Accordingly, no gain or loss is recognized on the partition of the trust for purposes of § 1001(a).

In addition, the present case is distinguishable from Rev. Rul. 69-486. Unlike the disguised transaction situation presented in the revenue ruling, here the terms of the original trust authorize non-pro rata partitions. Accordingly, the proposed partition will not be treated as a pro rata distribution followed by an exchange of assets among the beneficiaries of the original trust.

We conclude that the proposed division of the original trust will not constitute a taxable disposition under § 1001 of the Code.

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, resident or nonresident. Section 2511 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 the gift is made in property, the value thereof at the date of the gift is 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, that is included in computing the amount of gifts made during the calendar year.

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 the Trust as described above 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 the D Group Trust, The E Group Trust, and the F Group Trust, will not cause any beneficiary of Trust or of the separate trusts to have made a taxable gift for federal gift tax purposes under section 2501.

Ruling 4. Section 1015 provides that the basis in property acquired by a transfer in trust is the same as it would be in the hands of the grantor, with adjustments for gain and loss recognized.

Section 1.1015-2(a)(1) provides that in the case of property acquired after December 31, 1920 by a transfer in trust (other than a transfer in trust by gift, bequest or devise), the basis of property so acquired is the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor under the law applicable to the year in which the transfer was made.

Section 1.1015-2(a)(2) provides that the principles in section 1.1015-1(b) concerning the uniform basis are applicable in determining basis of property where more than one person acquires an interesting property by transfer in trust.

Section 1.1015(b) provides that property acquired by gift has a single uniform basis although more than one person may acquire an interest in the property. The uniform basis of the property remains fixed subject to proper adjustment for items under sections 1016 and 1017.

In this case, because neither section 1001 nor section 61 applies to the proposed transaction, the basis of the assets for each of the D Group Trust, the E Group Trust, and the F Group Trust will be the same as the basis of the assets in Trust.

Ruling 5. Section 1223(2) provides that in determining the period for which a taxpayer has held property, however, acquired, there is included the period for which the property was held by any other person, if under Chapter 1 of the Code, the property has, for the purposes of determining gain or loss from a sale or exchange, the same basis in whole or in part in the taxpayer’s hands as it would have in the hands of the other person.

We conclude that under section 1223(2) the holding period for each of the D Group Trust, the E Group Trust and the F Group Trust in each asset received from Trust will include the respective holding period of Trust for each such asset.

Ruling 6. Section 643(f) provides that under regulations prescribed by the Secretary, two or more trusts shall be treated as one trust if (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) the principal purpose of such trusts is the avoidance of the tax imposed by Chapter 1 of the Code.

The three trusts created by the division of Trust will have the same grantor, but will be separately managed and administered and have different primary beneficiaries. Therefore, the three trusts will be treated as separate trusts for federal income tax purposes.

The ruling contained in this letter is based upon information and representations submitted by the taxpayers 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.

Except as specifically ruled herein, we express or imply no opinion on the federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code.

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

Sincerely,

George Masnik
Chief Branch 4
(Passthroughs and Special Industries)

Enclosures
Copy for section 6110 purposes
Copy of this letter

cc: