

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200604015**

Release Date: 1/27/2006

Index Number: 2601.04-00, 1001.00-00,
1015.00-00, 1223.00-00,
643.06-00

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B09
PLR-133511-05
Date:
October 24, 2005

Decedent =
Date 1 =
Date 2 =
Spouse =
Child 1 =
Child 2 =
Date 3 =
State =
State Statute 1 =
State Statute 2 =

Dear :

This is in response to your authorized representative's letter dated May 25, 2005, requesting rulings on the income and generation-skipping transfer (GST) tax consequences of the division and modification of a trust that is exempt from the application of the GST tax under § 2601 of the Internal Revenue Code.

The facts and representations submitted are summarized as follows: Decedent died on Date 1, leaving a last will and testament dated Date 2. After providing for certain specific bequests, Article Eighth of Decedent's will provides that the residue of Decedent's estate shall be held in trust for the benefit of Spouse and Decedent's lawful issue.

Article Eighth, paragraph (h) of Decedent's will provides, generally, that the trust shall continue during the lives of Spouse and Decedent's youngest child surviving him and for twenty-one years after the death of the survivor of them. Upon the termination of the trust, the trust estate shall be distributed to Decedent's lawful issue then surviving by right of representation.

Article Eighth, paragraph (j) of Decedent's will provides, generally, that the trustee shall pay the net income of the trust at convenient intervals, at least quarterly, to Spouse as long as she survives. Upon Spouse's death, the portion of the net income to be paid to her shall be paid to Decedent's lawful issue by right of representation.

Upon Spouse's death, pursuant to Article Eighth, paragraph (j) of Decedent's will, the net income of the trust became payable to Decedent's children, Child 1 and Child 2. Child 2 passed away on Date 3 and his portion of the net income of the trust is now payable to his four children (Decedent's grandchildren).

The trust is governed by State law. It is represented that no additions or constructive additions have been made to the trust after September 25, 1985.

The parties represent that the investment goals and needs of the income beneficiaries have become divergent. Because of the differing investment goals, Child 1 has requested that the trustee sever the trust into two equal portions that will be treated as separate trusts ("New Trusts"). One of the New Trusts would be for the benefit of Child 1 and her issue ("Trust 1") and the other would be for the benefit of the issue of Child 2 ("Trust 2"). Trust 2 would continue to pay the net income to its current beneficiaries, while Trust 1 would convert, pursuant to State law, to a total return trust. Other than this change, the New Trusts will have terms identical to the original trust. The trust will be severed on a fractional basis and the assets allocated proportionately to the New Trusts.

State Statute 1 provides, in part, that unless expressly provided to the contrary in the trust instrument, the court may permit a trustee to sever any trust on a fractional basis into two or more separate trusts for any reason. A trust created by severance under State Statute 1 must be held on terms and conditions identical to those before the severance, or upon such terms or conditions that the aggregate interests of each beneficiary after the severance will be reasonably equivalent to that beneficiary's aggregate interests before the severance.

State Statute 2 provides that a trustee may, without court approval, convert an income trust to a total return unitrust if the trustee adopts a written statement regarding trust distributions that provides that future distributions from the trust will be unitrust amounts rather than net income, and indicates the manner in which the unitrust amount will be calculated and the method in which the fair market value of the trust will be determined.

The following rulings have been requested:

- (1) The exercise of the trustee's power to sever the trust on a fractional basis into two separate sub-trusts in accordance with State law will not adversely affect the trust's status as exempt from the GST tax and the two

sub-trusts created as a result of the severance will remain exempt from the GST tax;

(2) The exercise of the trustee's power to convert one of the sub-trusts to a total return trust in accordance with the total return trust provisions of State law, while treating the other sub-trust as a net income trust, will not adversely affect each trust's status as exempt from the GST tax, and the sub-trusts created as a result of the severance will remain exempt from the GST tax;

(3) The exercise of the trustee's power to sever the trust on a fractional basis into two sub-trusts in accordance with State law will not cause the trust, the sub-trusts or their beneficiaries to realize gain or loss from the sale or other disposition of property under § 1001 of the Code;

(4) After the severance of the trust, each asset of each sub-trust has the same basis and holding period that it had in the trust; and

(5) After the severance of the trust into two separate sub-trusts, each sub-trust is treated as a separate taxpayer under § 643(f).

Ruling Requests 1 and 2:

Section 2601 imposes a tax on every generation-skipping transfer.

Section 2611(a) defines the term "generation-skipping transfer" as a taxable distribution, a taxable termination, and a direct skip.

Under § 1433(b)(2)(A) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the generation-skipping transfer tax provisions do not apply to any generation-skipping transfer under a trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985. However, this exemption does not apply if additions (actual or constructive) are made to the trust after September 25, 1985.

Section 26.2601-1(b)(1)(ii)(A) provides that any trust in existence on September 25, 1985, will be considered an irrevocable trust except as provided in § 26.2601-1(b)(ii)(B) or (C), which relate to property includible in a grantor's gross estate under §§ 2038 and 2042. In the present case, the trust is considered to have been irrevocable on September 25, 1985, because neither § 2038 nor § 2042 applies.

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 § 26.2601-1(b)(1), (2), or (3)

(hereinafter referred to as an exempt trust) will not cause the trust to lose its exempt status. In general, unless specifically provided otherwise, the rules contained in § 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. Unless specifically noted, 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 gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(D)(1) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy § 26.2601-1(b)(4)(i)(A), (B), or (C)) 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, 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.

Section 26.2601-1(b)(4)(i)(D)(2) provides that for purposes of this section, 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. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a 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 modification. 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. In addition, administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)-1 of the Income Tax Regulations.

Section 26.2601-1(b)(4)(i)(E), Example 5, involves a trust that is irrevocable on or before September 25, 1985. 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 terms are identical except for the identity of the beneficiaries. 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 of the Internal Revenue Code.

Section 26.2601-1(b)(4)(i)(E), Example 8, illustrates a situation where a trust that is otherwise exempt from the GST tax provides that trust income is payable to A for life, and upon A's death, the remainder is to pass to A's issue, per stirpes. In 2002, the appropriate local court approves a modification to the trust that converts A's income interest into the right to receive the greater of the entire income of the trust or a fixed percentage of the trust assets valued annually (unitrust interest) to be paid each year to A for life. The example concludes that the modification does not result in a shift in beneficial interest 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 modification. Rather, the modification can only operate to increase the amount distributable to A and decrease the amount distributable to A's issue. In addition, 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. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

In the present case, the trust was established and became irrevocable on Date 1, and there have been no additions made to the trust after September 25, 1985. Accordingly, the trust is exempt from the GST tax under § 26.2601-1(b)(1).

Based on the facts submitted and the representations made, and provided that the appropriate State court permits the trustee to sever the trust into two separate sub-trusts, the severance of the trust into two sub-trusts, as described above, will not result in a shift of any beneficial interest in the trust to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the division. Further, the severance will not extend the time for vesting of any beneficial interest beyond the period originally provided for under the terms of the trust.

The conversion of one of the sub-trusts to a total return trust pursuant to State Statute 2 will not result in a shift of any beneficial interest to any beneficiary who occupies a lower generation than the beneficiaries holding the beneficial interests prior to the modification. Further, the conversion of one of the sub-trusts to a total return trust will not extend the time for vesting of any beneficial interest beyond the period originally provided for under the terms of the original trust. Accordingly, the severance of the trust

and conversion of one of the sub-trusts to a total return trust will not cause the trust or the sub-trusts to lose their GST exempt status.

Ruling Request 3:

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

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 § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized.

Section 1001(b) states that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. Under § 1001(c), except as otherwise provided in subtitle A, the entire amount of gain or loss, determined under § 1001, on the sale or exchange of property shall be 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 for 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 § 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 of the United States in Cottage Savings, 499 U.S. at 560-61, concluded that § 1.1001-1 reasonably interprets § 1001(a) and stated that an exchange of property gives rise to 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 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.

Under State Statute 1, a trustee has the power to “sever any trust on a fractional basis into two or more separate and identical trusts for any reason . . . unless expressly provided to the contrary in the trust instrument.”

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 trust. In accordance with State law, the trust will be divided on a fractional basis into two separate and identical trusts. Accordingly, the proposed transaction to divide the trust will not result in a material difference in kind or extent of the legal entitlements enjoyed by the beneficiaries, and no gain or loss is recognized by the beneficiaries or the trusts on the division for purposes of § 1001(a).

Ruling Request 4:

Section 1015(b) provides that if property is acquired by a transfer in trust (other than a transfer in trust by a gift, bequest, or devise), the basis shall be 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 on such transfer.

Section 1.1015-2(a)(1) provides that in the case of property acquired after December 31, 1920, by transfer in trust (other than by 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 on the transfer under the law applicable to the year in which the transfer was made. If the taxpayer acquired the property by transfer in trust, this basis applies whether the property be in the hands of the trustee, or the beneficiary, and whether acquired prior to termination of the trust and distribution of the property, or thereafter.

Section 1223(2) provides that, in determining the period for which the taxpayer has held property however acquired, there shall be included the period for which such property was held by any other person, if under Chapter 1 of Subtitle A such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person. See also § 1.1223-1(b).

Based upon the information submitted and representations made, we conclude that because § 1001 does not apply to the severance and conversion of the trust assets, under § 1015, the basis of the assets received by the two sub-trusts from the trust will be the same after the severance and conversion as the basis of those assets before the severance and conversion. Furthermore, pursuant to § 1223(2) the holding

period of each asset in the New Trusts will include the holding period of that asset in the hands of the original trust.

Ruling Request 5:

Section 643(f) provides that, for purposes of subchapter J of chapter 1 of subtitle A, 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) a principal purpose of such trusts is the avoidance of the tax imposed by chapter 1.

Section 1806(b) of the Tax Reform Act of 1986 provides that § 643(f) shall apply to taxable years beginning after March 1, 1984; except that, in the case of a trust which was irrevocable on March 1, 1984, it shall apply only to that portion of the trust which is attributable to contributions to corpus after March 1, 1984.

Based solely on the facts submitted and representations made, we conclude that as long as the New Trusts are separately managed and administered, they will be treated as separate trusts for federal income tax purposes.

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. If there is a change in material fact or law (local or federal) before the transactions considered in this ruling take effect, the ruling will have no force or effect. 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 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.

These rulings are 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.

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Melissa C. Liquerman
Branch Chief, Branch 9
(Passthroughs & Special Industries)

Enclosure

Copy of letter for § 6110 purposes