Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:4/PLR-115466-99
Date:
August 16, 2000

Legend:

Decedent -
Spouse -
Trust -
Child A -
Child B -
Grandchild 1 -
Grandchild 2 -
Grandchild 3 -

Dear :

This is in reference to the letter dated September 8, 1999, requesting rulings regarding the effect of the proposed judicial modification of the Trust instrument for federal income tax, gift tax and generation-skipping transfer (GST) tax purposes.

The submitted information is as follows:

Decedent executed Trust, a revocable trust, in 1964, the terms of which are governed by the laws of the State of California. Trust was amended in 1970. Child A, Decedent's child, is the sole trustee of Trust. Under the terms of Trust, the net income was paid monthly to Decedent during her life and, upon her death, specific amounts were paid to Decedent's children and grandchildren. The remaining corpus was to be divided into two equal shares, one for the benefit of Child A and the other for the benefit of Child B. If Child B and Child B's spouse predeceased Decedent without leaving lawful issue, Child B's share is to be added to Child A's share. Also, if Child B and Child B's spouse die after Decedent with no surviving lawful issue or if any issue of Child B die without lawful issue, Child B's share is to be added to Child A's share.

Under the terms of Trust, the income of Child A's share is to be distributed to Child A during his life. Upon Child A's death, one-half of the income is to be distributed to the issue of Child A, by right of representation, and the remaining income is to be distributed to Child A's spouse. Upon that spouse's death, that income is to be distributed to the issue of Child A, by right of representation. Trust is to terminate 21 years after the death of the survivor of Child A, Child B, and Child A's three children, Grandchild 1, Grandchild 2, and Grandchild 3 (who were all living on the date of creation of Trust). On termination, the trust corpus is to be divided among and distributed to the then current income beneficiaries in the same proportions as they were, at the time of termination, entitled to receive trust income. In the event that there are no surviving descendants of Child A prior to or upon termination of Trust, the income and corpus is to be distributed to two specified charitable organizations.

Decedent died in 1987, survived by Child A, Grandchild 1, Grandchild 2, Grandchild 3, their spouses, and Child A's grandchildren, including the spouse of a grandchild of Child A. Child B had predeceased Decedent and Child B's spouse died after Decedent. Child B had no issue. Consequently, you represent that, according to the terms of Trust, Child B's share of Trust was added to Child A's share, which represents the entire trust estate held for the benefit of Child A, the issue of Child A, and other contingent beneficiaries. You also represent that Decedent's Federal estate Tax return (Form 706) was filed timely and a letter from Decedent's attending physician was filed certifying that Decedent was incompetent to manage her affairs from March 1986, until her death in 1987. In addition, you represent that Spouse, the spouse of Child A , has waived her interest in Trust by means of a valid, enforceable prenuptial agreement.

You represent that there have been no additions, actual or constructive, to Trust after October 22, 1986.

Proposed Transaction

The trustee of Trust has received a judicial order from the appropriate local court modifying Trust upon issuance by the Internal Revenue Service of a favorable ruling. The judicial order provides that, upon the death of Child A, Trust will be divided into equal shares, one share for each surviving child of Child A and one share for each child of Child A who predeceased Child A and left surviving descendants. Each share will be administered as a separate trust (subtrust) and, to the extent possible, the trustee will allocate to each separate subtrust the assets that relate to the child of Child A and that child's issue for whom the separate trust is established. Each child of Child A will be the trustee of the separate subtrust established for his or her benefit. During the lives of each child of Child A for whom a subtrust is established the income from the respective subtrust will be paid at least annually to that child and, upon the death of the child, the income from that child's subtrust will be paid to that child's issue, by right of representation, for the duration of the subtrust. If, prior to termination of each subtrust, neither the child nor any of that child's lawful issue for whom the subtrust is established are living, augmentation provisions require the subtrust to terminate and the corpus to be distributed equally to the subtrusts established for the other children of Child A. If there are no such subtrusts in existence prior to the final termination date, the corpus will be distributed to the charitable organizations specified in Trust. Each child's subtrust will terminate no later than 21 years after the death of the last to die of Grandchild 1, Grandchild 2, and Grandchild 3. Upon termination, the corpus will be distributed to the then current income beneficiaries of the subtrust. Other than as described above, provisions of Trust will apply to each of the separate subtrusts established pursuant to this modification. Consequently, the dispositive provisions of the subtrusts will be consistent with the terms of Trust.

You represent that the proposed division of Trust is authorized under California law. Under § 15412 of the California Probate Code (West 1990), on petition by a trustee or beneficiary, the court, for good cause shown, may divide a trust into two or more separate trusts, if the court determines that dividing the trust will not defeat or substantially impair the accomplishment of the trust purposes or the interests of the beneficiaries.

You request rulings that:

1. The three subtrusts resulting from the proposed division of Trust will retain Trust's exempt status for generation-skipping transfer tax purposes under § 1433(b)(2)(C) of the Tax Reform Act of 1986 and § 26.2601-1(b)(3) of the Generation-skipping Transfer Tax Regulations.

2. The proposed division of Trust into the three subtrusts will not result in a transfer that is subject to gift tax.

3. The proposed division of Trust into the three subtrusts will not result in a disposition that is subject to federal income.

Issue 1 (The Generation-skipping Transfer Tax):

Section 2601 imposes a tax on every generation-skipping transfer. Under § 1431(a) of the Tax Reform Act of 1986 (the "Act") and § 26.2601-1(a)(1) of the Generation-Skipping Transfer Tax Regulations, the GST tax provisions apply to any generation-skipping transfer made after October 22, 1986.

Under § 1433(b)(2) of the Act and §26.2601-1(b)(1)(i) of the regulations, the tax does not apply to any generation-skipping transfer under a trust (as defined in section 2652(b)) that was irrevocable on September 25, 1985. This exemption, however, does not apply to a pro rata portion of any generation-skipping transfer under an irrevocable trust if additions are made to the trust after September 25, 1985. Section 26.2601-1(b)(1)(ii) provides that, except as provided in section 26.2601-1(b)(1)(ii)(B) (regarding property includible in the gross estate under section 2038) or (C) (regarding property includible in the gross estate under section 2042), any trust in existence on September 25, 1985, is considered an irrevocable trust.

Under § 1433 (b)(2)(C) of the Act and § 26.2601-1(b)(3)(i), if an individual is under a mental disability to change the disposition of his or her property continuously from October 22, 1986, until the date of his or her death, the GST tax provisions do not apply to any generation-skipping transfer (A) under a trust to the extent such trust consists of property, or the proceeds of property, the value of which was included in the individual's gross estate; or (B) which is a direct skip (other than a direct skip from a trust) that occurs by reason of the individual's death. Section 26.2601-1(b)(3)(ii) defines mental disability as mental incompetence to execute an instrument governing the disposition of the individual's property, whether or not there was an adjudication of incompetence and regardless of whether there has been an appointment of a guardian, fiduciary, or other person charged with either the care of the individual or the individual's property.

Section 26.2601-1(b)(3)(iii)(A) provides that if there has not been a court adjudication that the decedent was mentally incompetent on or before October 22, 1986, the executor must file, with Form 706, either -- (1) A certification from a qualified physician stating that the decedent was -- (i) mentally incompetent at all times on and after October 22, 1986; and (ii) did not regain competence to modify or revoke the terms of the trust or will prior to his or her death; or (2) Sufficient other evidence demonstrating that the decedent was mentally incompetent at all times on and after October 22, 1986, as well as a statement explaining why no certification is available from a physician; and (3) Any judgment or decree relating to the decedent's incompetency that was made after October 22, 1986. Section 26.2601-1(b)(3)(iii)(B) provides that such items will be considered relevant, but not determinative, in establishing the decedent's state of competency.

This exemption does not apply to additions (actual or constructive) that are made to the trust after October 22, 1986, unless the additions are made pursuant to an instrument or arrangement, which itself is covered by a transitional rule set forth in §§ 26.2601-1(b)(1), (2), (3). See 26.2601-1(b)(4). You have represented that no additions, actual or constructive, have been made to Trust after October 22, 1986.

A modification of a trust that is otherwise exempt for GST tax purposes will not result in a loss of its exempt status if the modification does not change the quality, value, or timing of any powers, beneficial interests, rights or expectancies originally provided for under the terms of the trust.

Under the proposed partition of the Trust after the death of Child A, each resulting subtrust will continue to be governed by provisions identical to those contained in Trust (except that each subtrust will be established for a child of Child A.) Unless terminated earlier under terms identical to those of Trust, each of the resulting subtrusts, under the terms of the partition, will terminate at the same time as specified under the terms of Trust. Thus, each of the resulting subtrusts will have substantive terms identical to those of the original trust and the parties' beneficial interests will not change.

We conclude that the proposed partition will not alter the quality, value or timing of any powers, or beneficial interests, rights or expectancies originally provided for under the terms of the Trust. Accordingly, the proposed modification of Trust pursuant to the judicial order, will not affect the exempt status of the Trust for GST purposes, and the resulting subtrusts will retain that exempt status. Assuming Decedent was under a mental disability as defined in § 26.2601-1(b)(3)(ii) on October 22, 1986, and remained under that disability continuously thereafter until the date of death, Trust and the subtrusts will not be subject to the generation-skipping transfer tax imposed under § 2601. Whether Decedent was under a mental disability at all times on and after October 22, 1986, is an issue to be determined by the Director District with audit jurisdiction over Decedent's federal estate tax return. Accordingly, this letter does not address that issue.

Issue 2 (The Gift Tax):

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.

In this case, the interest of each beneficiary will remain the same after the proposed partition of Trust upon the death of Child A. Accordingly, based on the facts submitted and the representations made, the partition will not cause the beneficiaries of Trust or any resulting subtrust to have made a taxable gift for Federal gift tax purposes under § 2501.

Issue 3 (The Income Tax):

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 § 1001 for determining loss over the amount realized.

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 conversion of property into cash, or from the exchange of property for other property differing materially either in kind or extent, is treated as income or loss sustained.

In Rev. Rul. 69-486, 1969-2 C.B. 159, distinguished by Rev. Rul. 83-61, 1983-1 C.B. 78, 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 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 and was subject to the provisions of § 1001 and § 1002 of the Code.

The present case is distinguishable from Rev. Rul. 69-486 because the trust document and applicable state law authorize the trustee to make a non-pro rata distribution of property in kind without any agreement by the beneficiaries. Thus, the new trusts to be created are not required to receive pro rata distributions for each asset of the original trust. Accordingly, the proposed transaction will not be treated as a pro rata distribution followed by an exchange of assets among the beneficiaries of the original trust.

Rev. Rul. 56-437, 1956-2 C.B. 507, held that the severance of a joint tenancy in stock under a partition action provided for by state law to compel the issuance of separate stock certificates is not a sale or exchange. Likewise, the conversion of a joint tenancy in stock into a tenancy in common is a nontaxable transaction. Under applicable state law the right of the owner of the property to pursue such a result is an inherent ownership right each had in the property involved.

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 of the Code. In Cottage Savings, a financial institution exchanged its interests in one group of residential mortgage loans for another group of residential mortgage loans. The two groups of mortgage loans were considered "substantially identical" by the agency that regulated the financial institution.

In Cottage Saving, at 499 U.S. at 560-561, the Supreme Court 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 Supreme Court stated that properties are "different" in a 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 564-565. The Supreme Court held that mortgage loans made to different obligors and secured by different homes embodied distinct legal entitlements, and that the taxpayer realized losses when it exchanged the loans. Cottage Savings, 499 U.S. at 566.

Thus, in order for a transaction to result in a § 1001 taxable event, the transaction must be (1) a sale, exchange or other disposition, and (2), if an exchange, the exchange must result in the receipt of property that is "materially different" (as defined in Cottage Savings) from the property that was given up. In this case, the first element will not be present because the beneficiaries of Trust do not acquire their interest in the subtrusts as a result of an exchange of their interests in the Trust, but rather by reason of the authority granted the under Cal. Probate Code § 15412. There is no exchange of property here, instead the trustee is merely exercising a right to divide Trust as allowed by California state law. In this, the transaction is similar to Rev. Rul. 56-437 in which the joint owners of property exercised a right inherent in their ownership rights of the property to partition the property.

Further, the Trust establishes that each of the trustees of the subtrusts will be required to continue to exercise the same standard of fiduciary responsibility as the trustee previously exercised with respect to Trust.

Therefore, the Trust, the three subtrusts, and the beneficiaries of any of these trusts will not realize gain or loss under § 1001 of the Code.

A copy of this letter should be attached to any income, gift, estate, or generation-skipping transfer tax returns that you may file relating to these matters.

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 the 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 set forth above, no opinion is expressed concerning the Federal tax consequences of the facts described above under the cited provisions or any other provision of the Code. In particular, no opinion is expressed concerning whether the Decedent was under a mental disability, as defined under § 26.2601-1(b)(3)(ii), on October 22, 1986, and continuously thereafter until Decedent's death.

This ruling is based on the facts presented and the applicable law in effect on the date of this letter. 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.

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

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to the trustee of Trust.

Sincerely,
Associate Chief Counsel
(Passthroughs and Special Industries)
By George Masnik
Chief, Branch 4

Enclosure
Copy for section 6110 purposes

cc: