Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
November 16, 2001

Legend

Trust =
Date 1 =
Grantor =
Spouse =
Date 2 =
Child 1 =
Child 2 =
Child 3 =
Child 4 =
Date 3 =
Letter 1 =

Court =
Grandchild 1 =
Grandchild 2 =

Dear Sir:

This letter responds to your letter, dated November 1, 2000, and subsequent correspondence, submitted on behalf of Trust, requesting rulings under §§ 61, 661, 1001, and 2601 of the Internal Revenue Code.

Trust was created on Date 1, by Grantor for the benefit of Spouse and the issue of Grantor and Spouse.

Article Two(a) of the Trust agreement provides the trustees may, in their discretion, accumulate the income of Trust and add it to principal or, at any time or from time to time, distribute any part or all of the income and principal of Trust to or among Grantor's lineal descendants and their spouses, and Spouse.

Article Two(b) provides that the distributions authorized under Article Two(a) may be outright or in further trust for any one or more of the classes among which the trustees may distribute. However, any distribution to a new trust shall be made so that no part of the income or principal of such new trust will at any time be distributed to any person to whom a distribution could not have been made under the Trust.

Article Two(c) provides that if not otherwise terminated sooner, Trust shall terminate twenty years and eleven months after the death of the last survivor of Spouse and all Grantor's lineal descendants living at the time of creation of Trust. Upon such termination, the trustees shall distribute all property remaining in Trust, including all principal and undistributed income, per stirpes, to those of Grantor's lineal descendants to whom the trustees were authorized to make distributions from such trust immediately before such termination. The members of the oldest generation of such descendants of which there is a member, living at the time when the interests vest, shall be taken to be the head of the respective stocks of lineal descendants.

Spouse died on Date 2. Grantor and Spouse had four children: Child 1, Child 2, Child 3, and Child 4. Currently, Child 1 has four children, Child 2 has three children and two grandchildren, Child 3 has two children, and Child 4 has two children.

After Spouse's death, the trustees decided to create subtrusts to benefit Grantor's grandchildren and fund them with distributions from Trust under the authority granted to them in the Trust agreement. On Date 3, the Internal Revenue Service ("Service") issued Letter 1, which concluded that Trust was irrevocable on September 25, 1985. In addition, the Service concluded that assuming that the subtrusts, including Subtrust H, created by the action of the trustees were authorized under the terms of Article Two of Trust, in accordance with applicable state law, then the transfer of assets from Trust to the various subtrusts would not be treated as an addition, actual or constructive, of corpus to Trust or to any of the subtrusts. The Service also concluded that each of the proposed subtrusts, including Subtrust H, would be considered to have been irrevocable on September 25, 1985.

Article Two(a) of the proposed Subtrust H provides that the trustees in their discretion may accumulate the income of the trust and add it to principal or may, at any time or from time to time, distribute any part or all of the income and principal of the trust to or among the Beneficiary Class that is active. The initial active Beneficiary Class shall consist of Grandchild 1, her lineal descendants, and "the spouses [sic] of Grandchild 1 and her [sic] lineal descendants." If no member of the initial Beneficiary

Class is living, then the Beneficiary Class that is active shall consist of Grandchild 2, his lineal descendants and "the spouses [sic] of Grandchild 2 and his [sic] lineal descendants." If no member of the second Beneficiary Class is living, then the Beneficiary Class that is active shall consist of Child 3's lineal descendants and their spouses. If no member of the third Beneficiary Class is living, then the Beneficiary Class that is active shall consist of the descendants of Child 1 and their spouses. If no member of the fourth Beneficiary Class is living, then the Beneficiary Class that is active shall consist of Grantor's other lineal descendants and their spouses.

Subtrust H would have been created under the approval of Letter 1 for the benefit of Grandchild 1, a child of Child 1. Funding of Subtrust H was delayed, however, because of additional modifications that needed to be made. The trustees have requested rulings regarding the gift, generation-skipping and income tax consequences of the proposed modifications. Funding of Subtrust H will not be made until a ruling is issued by the Service.

The trustees have proposed modifying Subtrust H to add a corporate administrative trustee to serve with the three general trustees and to provide a formula for the compensation of the administrative trustee. In addition, the trustees propose to modify Article Two(a) of Subtrust H to provide that the trustees in their discretion may accumulate the income of the trust and add it to principal or may, at any time or from time to time, distribute any part or all of the income and principal of the trust to or among the initial Beneficiary Class that is then active. The initial Beneficiary Class shall consist of Grandchild 1, her lineal descendants, "the spouses of Grandchild 1" and the spouses of her lineal descendants. If no member of the initial Beneficiary Class is living, then the second Beneficiary Class that is active shall consist of Grandchild 2, his lineal descendants, "the spouses of Grandchild 2" and the spouses of his lineal descendants. If no member of any prior Beneficiary Class is living, then the third Beneficiary Class that is active shall consist of the descendants of Child 1 and their spouses. If no member of any prior Beneficiary Class is living, then the fourth Beneficiary Class that is active shall consist of Child 1 and his spouse. If no member of any prior Beneficiary Class is living then the fifth Beneficiary Class that is active shall consist of the descendants of Child 3 and their spouses. If no member of any prior Beneficiary Class is living, then the sixth Beneficiary Class that is active shall consist of the descendants of Child 4 and their spouses. If no member of any prior Beneficiary Class is living, then the seventh Beneficiary Class that is active shall consist of all other descendants of Grantor and their spouses, except that Child 2 and her spouses shall never be deemed to be members of any Beneficiary Class under this Trust Agreement and shall never be entitled to principal or income herefrom. The dispositive terms of Subtrust H will otherwise be essentially the same as the dispositive terms of Trust.

You have requested the following rulings: (1) Subtrust H will be considered to have been irrevocable on September 25, 1985; (2) the transfer of assets from the Trust to Subtrust H will not be treated as an actual or constructive addition to Subtrust H for purposes of the effective date provisions of § 26.2601-1(b)(1)(i); (3) the division of each asset and the transfer of the divided assets from the Trust to Subtrust H will not cause

recognition of gain or loss under § 661 by either the Trust or Subtrust H, unless an election is made under § 643(e)(3); (4) the division of each asset and the transfer of the divided assets from the Trust to Subtrust H will not cause recognition of gain or loss under § 1001 by either the Trust or Subtrust H; and (5) the division of each asset and the transfer of the divided assets from the Trust to Subtrust H will not cause recognition of gain or loss by any of the beneficiaries of the Trust or of Subtrust H under §§ 61 or 1001.

Ruling Requests 1 and 2:

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

Section 2611(a) defines the term “generation-skipping transfer” to include a taxable distribution, taxable termination, and a direct skip.

Section 2612(a)(1) provides that the term “taxable termination” means the termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless (A) immediately after such termination, a non-skip person has an interest in such property, or (B) at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person.

Section 2612(b) provides that the term “taxable distribution” means any distribution from a trust to a skip person (other than a taxable termination or a direct skip).

Section 2612(c) provides that the term “direct skip” means a transfer subject to a tax imposed by chapter 11 or 12 of an interest in property to a skip person.

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 (GST) Regulations, the GST tax does 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 to additions (actual or constructive) that are made to the trust after September 25, 1985.

Section 26.2601-1(b)(1)(ii)(A) provides that, except as provided in § 26.2601-1(b)(1)(ii)(B) or (C), any trust in existence on September 25, 1985, is considered an irrevocable trust.

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. 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. 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 capital 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) of this section) 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 in the original trust.

Under § 26.2601-1(b)(4)(i)(D)(2), a modification that is administration 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 this case, the trustees have the authority under Article Two(a) and (b) to create Subtrust H for the benefit of Grandchild 1 and her lineal descendants and the spouses of her lineal descendants. The modification will not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation 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 in the original trust. Therefore, the proposed modification to Subtrust H will not affect the exempt status of Trust or Subtrust H.

In this case, the addition of a corporate administrative trustee and the provisions made for compensating such trustee are administrative in nature. Therefore, the addition of the corporate trustee will not affect the exempt status of Trust or Subtrust H. Based on the information submitted and the representations made, Subtrust H will be considered to have been irrevocable on September 25, 1985, and the transfer of assets from the Trust to Subtrust H will not be treated as an actual or constructive addition to Subtrust H for purposes of the effective date provisions of § 26.2601-1(b)(1)(i).

Ruling Request 3:

Section 643(e)(3)(A) provides that in the case of any distribution of property (other than cash) to which an election under § 643(e)(3) applies, (i) § 643(e)(2) does not apply, (ii) gain or loss is recognized by the trust in the same manner as if such property had been sold to the distributee at its fair market value, and (iii) the amount taken into account under §§ 661(a)(2) and 662(a)(2) shall be the fair market value of such property.

Section 643(e)(3)(B) provides that any election under § 643(e)(3) applies to all distributions made by the trust during a taxable year and is made on the return of the trust for such taxable year.

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

Section 1.661(a)-2(f) of the Income Tax Regulations provides that if property is paid, credited, or required to be distributed in kind no gain or loss is realized by the trust (or the other beneficiaries) by reason of the distribution, unless the distribution is in satisfaction of a right to receive a distribution in a specific dollar amount or in specific property other than that distributed.

Accordingly, we conclude that the Trust's distribution of property to Subtrust H will not cause the Trust to realize gain or loss, provided that the Trust does not make an election under § 643(e)(3).

Ruling Requests 4 and 5:

Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

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

Section 1.1001-1(a) provides generally that gain or loss realized from an exchange of property for other property differing materially either in kind or extent is treated as income or as loss sustained.

Rev. Rul. 56-437, 1956-2 C.B. 507, holds that the conversion of a joint tenancy into a tenancy in common is a nontaxable transaction. Likewise, the severance of a joint tenancy under a partition action pursuant to state law is a nontaxable transaction. In each situation, there is no sale or exchange and the taxpayers neither realized a taxable gain nor sustained a deductible loss.

Rev. Rul. 69-486, 1969-2 C.B. 159, holds that a non-pro rata distribution of trust corpus in kind by mutual agreement of the beneficiaries is subject to gain or loss treatment under § 1001. The trust instrument cited in the ruling did not contain a provision allowing the trustee to make a non-pro rata distribution and local law did not convey authority on the trustee to made a non-pro rata distribution of property in kind. Where neither the trust instrument nor local law convey authority on the trustee to make a non-pro rata distribution, the beneficiaries are viewed as having an absolute right to a

ratable in-kind distribution. Accordingly, the distribution was equivalent to a ratable distribution to the beneficiaries followed by an exchange between the beneficiaries that was subject to § 1001.

In Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), the Supreme Court addressed the issue of when an exchange of property gives rise to a realization event under § 1001. Under the facts of that case, 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 institutions. 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." 499 U.S. at 560-61.

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 entitlement that are different in kind or extent. 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 the loans. 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,” within the meaning of Cottage Savings, from the property that was given up.

Pursuant to Rev. Rul. 56-437, the severance of joint interests is not a sale or other disposition of property within the meaning of § 1001. Accordingly, the creation of Subtrust H and the distribution of assets from the Trust to Subtrust H will not cause recognition of gain or loss under § 1001 by either the Trust or Subtrust H.

The Trust authorizes the trustees to make distributions in further trust, provided that the beneficiaries of any newly created trust are limited to those persons eligible as beneficiaries under the Trust. Therefore, the beneficiaries of Subtrust H and Trust do not acquire their interests in Subtrust H and Trust as a result of the exchange of their interests in the Trust, but instead by reason of the authority granted to the trustees of the Trust to make distributions of Trust income or principal in further trust. The instant case is analogous to Rev. Rul. 56-437. In both instances, the taxpayers (in this case, the trustees) are exercising their authority granted in the controlling document or pursuant to state law. For this reason, the exercise of the trustee’s power also is distinguishable from the trustee’s distribution in Rev. Rul. 69-486, which was not authorized by the controlling document or by state law. The creation of Subtrust H and the distribution of assets from the Trust to Subtrust H will not cause recognition of gain or loss by any of the beneficiaries of the Trust or Subtrust H.

Except as expressly provided herein, no opinion is expressed or implied concerning the federal 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.

Pursuant to the Power of Attorney on file with this office, a copy of this letter is being sent to Trustee.

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

Sincerely,
James F. Hogan
Senior Technician Reviewer
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures
Copy for § 6110 purposes
Copy of this letter