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Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:4-PLR-131740-01
Date:
MAY 17, 2002

In Re:

Legend

Decedent =

Daughter =

Son =

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Trust 5 =

Date 1 =
Date 2 =
Date 3 =
State =

Dear :

This responds to a letter from your authorized representative dated May 31, 2001, and subsequent correspondence, requesting rulings regarding the income, gift and generation-skipping transfer (GST) tax consequences of the proposed consolidation of certain trusts.

FACTS

The facts submitted and representations made are as follows. Trust 1, an irrevocable inter vivos trust, was created by Decedent on Date 1. Pursuant to the trust instrument, upon Decedent's death Trust 1 was divided into two equal trusts, Trust 4 and Trust 5. Trust 2 and Trust 3 were established upon Decedent's death pursuant to another trust instrument executed by Decedent on Date 2. Decedent died on Date 3. Date 1, Date 2, and Date 3 are subsequent to September 25, 1985.

Trust 2 and Trust 4 are for the benefit of Daughter; Daughter is trustee of Trust 2 and Trust 4. Trust 3 and Trust 5 are for the benefit of Son; Son is trustee of Trust 3 and Trust 5. With the exceptions noted below, the terms of Trust 2, Trust 3, Trust 4, and Trust 5 are substantially the same. Each trust instrument provides for the distribution of 80% of the income at least annually to the child for whom the trust (or separate share) was established, or unless otherwise appointed by the child, per stirpes to the issue of that deceased child. Trust 4 and Trust 5 provide for the distribution of principal as follows:

> Principal. Until the time for termination and liquidation of a separate trust . . . Trustee shall distribute principal from each separate trust for the proper health, education, maintenance, and support of the child for whom the trust was established or, unless otherwise appointed by that child pursuant to subsection (4) of this Section D, ARTICLE III, for the proper health, education, maintenance, and support of the issue of that child.

Similarly, Trust 2 and Trust 3 provide for the distribution of principal "for the proper health, education, maintenance, and support of the child for whom the trust was established or, unless otherwise appointed by that child..., for the proper health, education, maintenance, and support of the issue of that child." Trust 2, Trust 3, Trust 4, and Trust 5 provide each child of the Decedent for whom the trust (or separate share) is established, or the issue of such deceased child, with a special power of appointment for the benefit of other issue of the Decedent.

With respect to the termination of Trust 4 and Trust 5, Article III, Section D.(3) of the trust instrument provides:

> Termination. Subject to the possible exercise of that power of appointment ..., the trusts established hereunder shall terminate on the later of (a) twenty-one (21) years after the death of the last survivor of such of the issue of Settlor who are beneficiaries of the trust and living upon execution of this Trust, or (b) 90 years after the trust's creation, or (c) such longer duration as applicable law affecting the relevant trust may permit. The foregoing alternate conditions shall be applied using the [State] Uniform Statutory Rule Against Perpetuities law and rules of construction, as amended, and construction

> providing for the longest duration of trusts created hereunder. Except as provided below, upon termination, the entire principal and income shall be distributed per stirpes to the issue of the child for whom the trust was, or was intended to be, established. If a child dies without issue, his or her share shall be proportionally divided amongst the other shares existing at such time. If no issue of Settlor exist at any time or the term hereof expires without issue of Settlor surviving, the Trust Estate shall be disposed of under the rules of intestacy of the State of [State].

Article V, Section A.(3) of Trust 2 and Trust 3 provides:

> Termination. Subject to the possible exercise of that power of appointment..., the trusts established hereunder shall terminate on the later of (a) twenty-one (21) years after the death of the last survivor of such of the issue of Settlor who are living at Settlor's death and beneficiaries of the trust to be terminated, or (b) 90 years after Settlor's death. The foregoing alternate conditions shall be applied using the [State] Uniform Statutory Rule Against Perpetuities law and rules of construction, as amended. However, if the Internal Revenue Service or state law hereafter limited the generation-skipping tax exemption available to this trust to a shorter period of perpetuities limitation than [State] law permits, the shorter limitations period shall apply so to preserve the limitations. Upon termination, the entire principal and income shall be distributed per stirpes to the issue of the child for whom the trust was, or was intended to be, established.

The parties propose to consolidate Trust 4 into Trust 2 and Trust 5 into Trust 3. The trust instruments governing Trust 2, Trust 3, Trust 4, and Trust 5 expressly permit consolidation with other trusts created by any person with the same beneficiaries, trustees, and substantially the same dispositive provisions. You represent that, under the law of State, the parties are not required to seek court approval to consolidate the trusts.

As a result of the termination provisions in the trust instruments, the eventual termination dates of Trust 4 and Trust 5 may differ from the eventual termination dates of Trust 2 or Trust 3. Therefore, at the time the assets of Trust 4 and Trust 5 are merged into Trust 2 and Trust 3, the value of each of Trust 2, Trust 3, Trust 4, and Trust 5 will be established in order to comprise a proportionate percentage of the entire combined trust's initial value. In the event that it becomes necessary to subsequently separate one of the combined trusts, the amount separated will be determined by use of the following formula: the value of the combined trust upon separation will be multiplied by a fraction, the numerator of which will be the fair market value of the share of the applicable original trust as of the date of the consolidation, and the denominator of which will be the fair market value of the shares of the combined trusts as of the date of the consolidation.

You represent that the assets of Trust 2, Trust 3, Trust 4, and Trust 5 consist of cash, marketable securities and/or real estate. You also represent that Trust 2, Trust 3, Trust 4, and Trust 5 each have a GST tax inclusion ratio of zero by virtue of Decedent's allocation of his GST tax exemption to inter vivos gifts to the trusts or the allocation of the exemption to the trusts on Decedent's Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return by Decedent's executors.

You have requested the following rulings:

1. The consolidations of Trust 4 into Trust 2 and Trust 5 into Trust 3 will not subject Trust 2, Trust 3, Trust 4, or Trust 5 or any distributions from Trust 2, Trust 3, Trust 4, or Trust 5 to the GST tax.

2. The consolidations of Trust 4 into Trust 2 and Trust 5 into Trust 3 will not constitute actual or constructive additions to any of the trusts for purposes of the GST tax.

3. Following the consolidations of Trust 4 into Trust 2 and Trust 5 into Trust 3, Trust 2 and Trust 3 will be exempt from the GST tax.

4. The consolidations of Trust 4 into Trust 2 and Trust 5 into Trust 3 will not cause any beneficiary of a trust or any beneficiary of the consolidated trusts to have made a taxable gift for Federal gift tax purposes.

5. The consolidations of Trust 4 into Trust 2 and Trust 5 into Trust 3 will not cause any trust or consolidated trust to recognize any gain or loss from the sale or other disposition of property under § 61 or § 1001.

6. Pursuant to § 1015, the basis of the consolidated trusts in each asset received will be the same as the transferring trust's basis in such asset.

7. Pursuant to § 1223(2), the holding period of each asset transferred to Trust 2 or Trust 3 will include the period for which the property was held by the transferring trust.

LAW AND ANALYSIS

Generation-Skipping Transfer Tax Ruling Requests Nos. 1, 2, and 3

Section 2601 of the Internal Revenue Code imposes a tax on each generation-skipping transfer made by a transferor to a skip person.

Under § 1433(a) of the Tax Reform Act of 1986 (Act), the generation-skipping transfer tax is generally applicable to generation-skipping transfers made after October

22, 1986. However, under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to any generation-skipping transfer from a trust, if the trust was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date. Under § 26.2601-1(b)(1)(ii), any trust in existence on September 25, 1985, will be considered irrevocable unless the settlor had a power that would have caused inclusion of the trust in his or her gross estate under §§ 2038 or 2042, if the settlor had died on September 25, 1985.

Section 2602 provides that the amount of the tax imposed by § 2601 is (1) the taxable amount (determined under subchapter C), multiplied by (2) the applicable rate (determined under subchapter E).

Section 2641 provides that the term “applicable rate” means, with respect to any generation-skipping transfer, the product of (1) the maximum Federal estate tax rate, and (2) the inclusion ratio with respect to the transfer.

Section 2631(a) provides that for purposes of determining the inclusion ratio, every individual is allowed a GST exemption of $1,000,000 (adjusted for inflation) that may be allocated by such individual (or his executor) to any property with respect to which such individual is the transferor.

Section 2642(a) provides that the inclusion ratio is the excess, if any, of 1 over the applicable fraction determined for the trust from which the transfer is made, or in the case of a direct skip, the applicable fraction determined for the skip. The applicable fraction is a fraction in which the numerator is the GST exemption allocated to the trust, or in the case of a direct skip, allocated to the property transferred in the skip, and the denominator is the value of the property transferred to the trust or transferred in the direct skip, reduced by any Federal estate tax or State death tax actually recovered from the trust attributable to the property and any charitable deduction allowed under §§ 2055 and 2522 with respect to the property.

Section 26.2642-4(a)(2) provides that if separate trusts created by one transferor are consolidated, a single applicable fraction for the consolidated trust is determined. The numerator of the redetermined applicable fraction is the sum of the nontax portions of each trust immediately prior to the consolidation. Under § 26.2642-4(a), the nontax portion of each trust is determined by multiplying the value of the trust assets determined immediately prior to the consolidation by the then applicable fraction.

It is represented that Trust 2, Trust 3, Trust 4, and Trust 5 each have an inclusion ratio of zero by virtue of timely and adequate allocations of Decedent’s GST exemption to the property that passed to the trusts during Decedent’s lifetime or at Decedent’s death. There have been no other additions or contributions to any of the

trusts. As a result, the inclusion ratio of each trust prior to the consolidations is zero. Therefore, subsequent to the consolidation of Trust 4 into Trust 2, Trust 2 will have a zero inclusion ratio for purposes of the GST tax imposed by § 2601. Similarly, after the consolidation of Trust 5 into Trust 3, Trust 3 will have a zero inclusion ratio for purposes of the GST tax imposed by § 2601.

Therefore, based on the facts submitted and representations made, we conclude:

1. The consolidations of Trust 4 into Trust 2 and Trust 5 into Trust 3 will not subject Trust 2, Trust 3, Trust 4, or Trust 5 or any distributions from Trust 2, Trust 3, Trust 4, or Trust 5 to the GST tax.

2. The consolidations of Trust 4 into Trust 2 and Trust 5 into Trust 3 will not constitute actual or constructive additions to any of the trusts for purposes of the GST tax.

3. Following the consolidations of Trust 4 into Trust 2 and Trust 5 into Trust 3, Trust 2 and Trust 3 will be exempt from the GST tax.

Gift Tax Ruling Request No. 4

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.

Section 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.

In this case, the interest of each beneficiary will remain the same after the proposed consolidation of Trust 4 into Trust 2 and Trust 5 into Trust 3 as it was prior to the proposed transaction. Accordingly, based on the facts submitted and the representations made, we conclude that the consolidation of Trust 4 into Trust 2 and Trust 5 into Trust 3 will not cause any beneficiary of an existing trust or any beneficiary of a consolidated trust to have made a taxable gift for Federal gift tax purposes.

Income Tax Ruling Requests Nos. 5, 6, and 7

Section 61(a)(3) 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 shall be the excess of the amount realized over the adjusted basis provided in

§ 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized. Section 1001(c) provides that, 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, except as otherwise provided in subtitle A, 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.

For purposes of § 1001, in an exchange of property, each party to the exchange gives up a property interest in return for a new or additional property interest. Such an exchange of property is a disposition under § 1001(a). See § 1.1001-1.

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 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 if 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 embodied distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans.

Based on the information submitted and the representations made in the ruling request, the trustees will hold the same property after consolidation as before, and each beneficiary will possess the same income and remainder interests. Accordingly, no sale or exchange under § 1001 will occur as a result of the consolidations.

Section 1015(b) 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 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 the property was held by any other person, if under chapter I the property has, for the

purpose 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.

Accordingly, based on the facts submitted and the representations made, we conclude:

5. The consolidations of Trust 4 into Trust 2 and Trust 5 into Trust 3 will not cause any trust or consolidated trust to recognize any gain or loss from the sale or other disposition of property under § 61 or § 1001.

6. Pursuant to § 1015, the basis of the consolidated trusts in each asset received will be the same as the transferring trust's basis in such asset.

7. Pursuant to § 1223(2), the holding period of each asset transferred to Trust 2 or Trust 3 will include the period for which the property was held by the transferring trust.

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

The rulings contained in this letter are based upon information and representations submitted by the trustee 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.

This ruling 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 ruling is being sent to your authorized agent.

Sincerely yours,
By:Lorraine E. Gardner
Assistant to the Branch Chief, Branch 4
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure
Copy for section 611 0 purposes

cc: