Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200409003**
Release Date: 2/27/04
Index Number: 1001.00-00, 2501.00-00, 2601.00-00

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
[CC:PSI:04 – PLR-114823-03
Date:
November 06, 2003

In Re:

LEGEND:

Trustor =

Son =

D =

E =

F =

G =

H =

L =

M =

N =

O =

P =

Q	=
Bank	=
State	=
Court	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
State Statute 1	=
$x	=
z%	=
Year 1	=
Year 2	=
Year 3	=

Dear :

This is in response to your correspondence dated January 29, 2003, requesting a ruling concerning the income, gift, and generation-skipping transfer tax consequences of the proposed severance and modification of Trust under §§ 1001, 2501, and 2601 of the Internal Revenue Code.

The facts and representations submitted are summarized as follows: Trust was created on Date 1, prior to September 26, 1985, by Trustor.

The pertinent provisions of Trust are summarized as follows.

Under Article 1 of Trust, Son is to be paid $x out of the net income of Trust for Son's lifetime, and if the net income is less than $x, then Son is to be paid all trust income. Son may also be paid, pursuant to Article 2, from the net income of Trust, additional amounts as the trustee, in its discretion may determine to be wise and for Son's best interests.

Article 3 provides that the net income remaining after the payments authorized to be made to Son, is referred to as "accumulated principal." This accumulated principal is to be allocated to principal, accumulated and kept separate and apart from the other principal of the trust estate to be invested. Under Article 4, if Son attains the age of 30 years, one-half the value of the "accumulated principal" is to be assigned and transferred to Son. Upon Son attaining age 40, two-thirds of the "accumulated principal" remaining in Trust is to be transferred and assigned to him. Upon attaining age 50, all of the remaining "accumulated principal" is to be then transferred to Son.

Article 6 provides that upon the death of Son, the entire yearly net income of Trust is to be paid in equal shares each year to Son's children and the issue of any deceased child by right of representation. When the youngest child or grandchild of Son living at the time of his death has attained the age of 21, or if such youngest has attained the age of 21 at the time of the death of Son, Trust is to terminate and all of the property remaining is to be divided equally among the then living children of Son and the then living issue of Son's deceased children. The issue of a deceased child of Son is to take by right of representation the share that the deceased child would have taken if living.

Under Article 7, if Son dies leaving children who all die before the time fixed for the distribution of the trust funds, Trust is to terminate upon the death of the last survivor of the children and the Trust estate is to paid and distributed per stirpes, to the then living issue of the deceased children of Son.

Article 8 provides that if Son dies without leaving children, or if Son dies leaving children all of whom die before the time fixed for distribution of the Trust estate, and without leaving issue surviving at the death of the last survivor of Son's children, all of the property remaining in the trust is to be assigned, transferred to and divided equally among trusts designated as the L Trust, M Trust, N Trust, and O Trust, all of which were created by Trustor. If such trusts have previously terminated and there is no living issue of any of the persons for whom the trust was designated, then the Trust property is to be assigned and distributed equally to and among the heirs-at-law of the children of Trustor, L, M, N, O, and Son, in accordance with the laws of State then in force regulating the descent of personal property for those who die intestate.

Under Article 9, while any beneficiary entitled to any part of the income of the Trust estate is a minor, such income may be paid to the minor's parents or guardian for the use and benefit of the minor, or the trustees may apply to the maintenance, education and support of such minor, such part of the income to which the minor may be entitled to as the trustees determine. If any part of the net income is accumulated by the trustees while the beneficiary is a minor, the accumulation is to be paid over to him or her if and when he or she attains majority.

Article 10 provides that notwithstanding any other provision of Trust, Trust is to terminate no later than 21 years after the death of the last survivor of the L, M, N, O, and Son. On termination, the Trust property is to be distributed and paid over to the beneficiaries named or designated as near as may be in accordance with the intent of the Trust instrument, even though the time for distribution may not otherwise under the provisions of Trust have arrived, and notwithstanding that any beneficiary may not have attained the age at which he or she would otherwise be entitled to share in the distribution.

Son died on Date 2, after having attained the age of 50. Son was survived by 5 children, D, E, F, G, and H, all of whom were of legal age and under no disability, and several grandchildren. Son was not survived by any issue of a deceased child.

On Date 4, the appropriate local court issued an order confirming that under Article 6, Trust will terminate on Date 5.

In Year 1, Court issued an order modifying the original terms of Trust to provide that: (1) The State Uniform Principal and Income Act, governs the interpretation of Trust; (2) Any consideration received by the trustees on the sale of trust assets after the date of death of Son is to be considered principal; (3) Gains on the sale of trust assets are not included in the calculation of the net income of the trust distributable to the income beneficiaries; and (4) State Statute defining charges to income and principal is applicable to Trust after the death of Son. Taxes on gains allocated to the sale of principal assets after the death of Son are to be charged to principal.

Currently, trust income is being distributed to D, E, F, F, G and H in equal shares. Since its inception, Trust has been administered as a single trust. Trust filed a single fiduciary income tax return and the trustees maintain a single account for all of the Trust assets.

The current trustees of Trust are H and Bank.

On Date 3, the trustees petitioned Court for approval of three modifications to Trust:

(1) The trustees petitioned Court to approve the division of Trust into five separate shares, pursuant to State law. It is represented that the Trust will be divided on a pro-rata basis into five separate trusts. Each share will be governed by the same

trustees and the same Trust terms. Each separate trust will provide that until the termination date of Trust, the entire net income of each separate share is to be paid to the child of Son for whom the share is set aside and to the issue of any deceased child by right of representation. Upon the termination date of Trust, all of the assets of each separate trust are to be paid over to the then living child of Son for whom the separate trust was set aside, or to the then living issue of any child of Son who is then deceased, by right of representation.

(2) State Statute 1 authorizes the trustees of a trust to make adjustments between income and principal, thereby permitting the trustees to invest under a "total return" theory. Accordingly, trustees petitioned Court and Court approved the modification of each severed trust to provide that in Year 2, the trustees are to distribute to the trust income beneficiary an amount equal to the greater of trust income or z% (the "unitrust amount") of Trust's fair market value, as determined as of the first business day of the year.

For Year 3 and thereafter, the trustees will distribute to the income beneficiary of each trust share the greater of the net income of the trust share or a unitrust amount. The unitrust amount will vary from year to year and will also be determined separately for each trust. However, in no event will the distribution for the year be less than the net income of the trust share.

State Statute 1 sets forth a number of conditions that must be satisfied prior to making an adjustment between income and principal. It is represented that the proposed distribution would only take place once the trustees have complied with all of the conditions set forth in State Statute 1. In addition, all decisions relating to adjustment will be made by the corporate trustee, not the individual trustee. H, as individual trustee, may not exercise the power to make an adjustment because H is also a beneficiary. H, therefore, expressly released his power as trustee to exercise the power of adjustment.

(3) Court's Year 1 order did not anticipate subsequent legislative changes which permit adjustments to principal and distributions of principal. Accordingly, the trustees petitioned Court for further guidance on this issue. The petition notes that, as a result of legislative changes made since Year 1, distributions from Trust will raise issues regarding the allocation of taxable gains and the payment of taxes on the gains, between the Trust and the Trust beneficiaries. Accordingly, petitioners requested the Court to modify it's Year 1 order to provide that gains attributed to the sale of principal assets are to be included in distributable net income and losses for income tax purposes to the extent provided by federal income tax law and applicable Income Tax Regulations.

On Date 3, the court issued its order granting the trustee's petition for the modifications herein described, subject to a favorable ruling from the IRS.

The following rulings are requested:

1. The proposed division of Trust into five equal trusts will not cause Trust or the five separate trusts to lose their exemption from the generation-skipping transfer (GST) tax and will not subject the separate trusts or the beneficiaries to GST tax, provided that there are no additions to Trust or to the five separate trusts after September 25, 1985.

2. The proposed modifications to Trust provide that the trustees will distribute each year the greater of trust income, or a unitrust amount, as described above, and that capital gains and losses will be included in distributable net income, to the extent provided under federal income tax law and the applicable Income Tax Regulations. These modications, will not cause Trust or the successor trusts to lose exempt status for GST tax purposes.

3. The proposed division of the Trust assets among the successor trusts will not cause the separate trusts nor the beneficiaries to recognize any gain or loss from a sale or other disposition of property under sections 61 and 1001 of the Code.

4. The proposed division of Trust into five separate trusts will not result in a transfer subject to the gift tax under section 2501, by any beneficiary of Trust or the five separate trusts.

LAW AND ANALYSIS

Rulings 1 and 2. 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.

Section 26.2601-1(b)(4)(i)(E), Example 8, considers a situation where Grantor established an irrevocable trust under the terms of which 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 modification does not result in a shift in beneficial interest to a beneficiary who occupies a lower generation (as defined by section 2651) than the person or persons who held the beneficial interest prior to the modification. In this case, 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 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 five 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 five equal fractional interest trusts will not cause Trust or any partitioned trusts to lose exempt status under § 1433(b)(2)(A) of the Tax Reform Act of 1986.

As a result of the modifications of Trust, D, E, F, G, and H will each be paid annually the greater of the net income of their respective trust, or a unitrust amount to be determined by the trustee from year to year. However, in no event will the amount distributed be less than the separate trust's income. In addition, capital gains and losses will be included in the distributable net income of each separate trust, in accordance with federal income tax law and the applicable regulations. We conclude that these modifications will not result in a shift in a beneficial interest to any beneficiary that occupies a lower generation than D, E, F, G, and H, the beneficiaries holding the beneficial interests prior to modification. Further, the modifications will not extend the time for vesting of any beneficial interest beyond the period originally provided for under the terms of Trust. Accordingly, the modifications as proposed will not cause Trust, or the partitioned trusts to lose their exempt status.

Taxpayers authorized representative has represented that a conforming modification to the Court's Order of Date 3, will be made in accordance with the discussion of this issue with representatives of this office.

Ruling 3. 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 is the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss is the excess of the adjusted basis provided in section 1011 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 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 section 1001, in an exchange of property, each party to the exchange gives up a property interest in return for a new additional property interest. Such an exchange of property is a disposition under section 1001(a). See § 1.1001-1.

An exchange of property results in the realization of gain under section 1001 if the properties exchanged are materially different. Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991). A material difference exists when the exchanged properties embody legal entitlements "different in kind of extent" of if they confer "different rights and powers." Id. at 565.

Based upon the information submitted and the representations made in the ruling request, the proposed division of Trust on a pro-rata basis into five separate trusts will not cause the interests of the trust beneficiaries to differ materially. The trust beneficiaries will hold essentially the same interests before and after the pro-rata division. Accordingly, the proposed division of Trust assets among the successor trusts will not cause the trusts nor the beneficiaries to recognize any gain or loss from a sale or other disposition of property under sections 61 and 1001.

Ruling 4. Section 2501(a)(1) provides the general rule for taxable transfers that a tax, computed as provided in section 2502, is hereby imposed for each calendar year on the transfer of property by gift during such calendar year by any individual, resident or nonresident.

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 five separate trusts, 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.

In accordance with the power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

A copy of this letter should be attached to any gift, estate, or GST tax returns that you may file relating to this matter.

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 part of the material submitted in support of the request for rulings, it is subject to verification and examination.

Except has specifically ruled above, no opinion is expressed as to the federal tax consequences of the facts described above under the cited provisions or any other provisions of the Code or regulations. We are not expressing any opinion on the gift tax consequences of the modification of Trust directing trustee to distribute the greater of trust income or a unitrust amount to the trust beneficiary.

This ruling is 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.

George Masnik
Branch Chief
Branch 4
Office of Associate Chief Counsel
(Passthrough and Special Industries)

Enclosure
Copy of letter for section 6110 purposes

Cc: