Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B09
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Date:
September 14, 2004

In Re:

Legend:

Trust 1 =

Trust 2 =

Decedent =
Grandson =
Date 1 =
Date 2 =
Foundation 1 =
Child 1 =
Child 2 =
Foundation 2 =
Date 3 =
Corporate Trustee =

Dear :

This is in response to your letter dated December 8, 2003, submitted on behalf of the trustee of Trust 1 and Trust 2, requesting rulings on the income, gift, and generation-skipping transfer (GST) tax consequences of a proposed merger of two trusts.

The facts and representations submitted are summarized as follows: Decedent established two irrevocable trusts for the primary benefit of Grandson. Trust 1 was established on Date 1 and Trust 2 was established on Date 2.

Article Two of Trust 1 provides, generally, that the trust is irrevocable and that Decedent has no right with respect to the property or income of Trust 1.

Article Three provides for the disposition of trust income and principal. Article Three, paragraph 1 provides that before the beneficiary attains the age of twenty-one years, the trustees have the discretion to distribute or accumulate income or to distribute trust principal.

Article Three, paragraph 2 provides that after the beneficiary has attained the age of twenty-one years, the trustees have the discretion to distribute or accumulate income or to distribute trust principal. The power of the trustees to distribute or withhold income, accumulated income or principal shall be limited by the needs and circumstances of the beneficiary.

Article Three, paragraph 3 provides that in the event of the death of the beneficiary prior to the termination of the trust, the surviving issue of the beneficiary shall then become entitled by right of representation to the remaining property of the trust, the share of each of the beneficiary's children (Decedent's great-grandchildren) to be held in a separate trust for the benefit of such child and the shares of issue more remote than great-grandchildren to be distributed to them. If a beneficiary should die without issue surviving, the remaining trust property shall be divided equally among and added to all other trusts then in existence for Decedent's grandchildren under agreements with Decedent bearing the same date as this agreement; provided, however, that the trusts then in existence under any such agreement for children of a deceased grandchild shall receive, in equal parts, the share which would otherwise have been added to the trust under such agreement for such deceased grandchild. As to the accumulation and distribution of income and the distribution of principal of the trusts for Decedent's great-grandchildren, the trustees shall have the same powers as they have respecting the original trust hereunder for the original beneficiary.

Article Three, paragraph 4 provides that in the event of the death of the beneficiary after attaining the age of twenty-one years, the beneficiary is granted a limited power of appointment over accumulated and accrued income. In default of exercise of such power by the beneficiary, all such accrued and accumulated income shall be distributed along with the trust principal in the same manner as is provided in paragraph 3.

Article Three, paragraph 5 provides that upon the death of a great-grandchild of Decedent, the remaining property of his trust shall be distributed to his issue by right of representation or, if he should have died without issue surviving, shall be added, in equal parts, to any trusts then in existence under this agreement for the benefit of his

surviving brothers and sisters; and if no such trusts shall then exist, such share shall be divided equally among and added to the trusts then in existence for Decedent's grandchildren under agreements with Decedent bearing the same date as this agreement; provided, however, that the trusts then in existence under any such agreement for children of a deceased grandchild shall receive, in equal parts, the share which would otherwise have been added to the trust under such agreement for such deceased grandchild.

Article Three, paragraph 9 provides that if at any time there should remain any trust property for the distribution of which no other provision is made in this agreement, such property shall be distributed in equal shares to Decedent's then living grandchildren and to the living issue of deceased grandchildren of Decedent, but if neither grandchildren nor issue of grandchildren should be living, the same shall be distributed to Foundation 1.

The trustees of Trust 1 shall be Decedent's sons, Child 1 and Child 2, neither of whom is the parent of Grandson.

The terms of Trust 2 are identical to those of Trust 1, except that the ultimate contingent charitable beneficiary of Trust 2 is Foundation 2. Decedent died on Date 3. Child 1 and Child 2 appointed Corporate Trustee as trustee of Trust 1 and Trust 2 and subsequently resigned. It is represented that no additions or constructive additions have been made to Trust 1 or Trust 2 after September 25, 1985.

Pursuant to an agreement reached by Corporate Trustee and the current beneficiaries, the parties propose to merge Trust 1 into Trust 2. The purpose of the proposed merger is to continue harmony between the existing beneficiaries of both Trust 1 and Trust 2, and to bring about administrative convenience and efficiency. The substantially identical terms of Trust 1 and Trust 2 shall continue to govern the successor trust. It is represented that since Trust 1 and Trust 2 provide for different contingent charitable beneficiaries, an agreement will be executed by the trustee and the current beneficiaries. The agreement will provide that in the event all beneficiaries die prior to the termination of the merged trusts, the remaining trust assets will be distributed to Foundation 1 and Foundation 2 in proportion to the value of the pre-merger trust for which they were the final contingent beneficiaries, as of the date of the merger.

The following rulings have been requested:

(1) Trust 1 and Trust 2 are currently exempt from the GST tax under § 2601;

(2) The proposed merger of Trust 1 into Trust 2 will not affect the grandfathered status of the trusts and will not cause any distributions from the merged trusts or distributions upon termination of the merged trusts to

become subject to the GST tax provided there are no post-merger additions to the merged trusts;

(3) The proposed merger will not constitute or cause taxable gifts to be made under § 2511;

(4) No gain or loss will be recognized under § 1001 upon the merger of Trust 1 into Trust 2; and

(5) The assets of the merged trusts will have the same basis and holding period under §§ 1015 and 1223 both before and after the proposed merger.

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 relates to property includible in a grantor's gross estate under §§ 2038 and 2042.

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 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)) 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.

Section 26.2601-1(b)(4)(i)(E), Example 6, provides that in 1980, Grantor established an irrevocable trust for Grantor's child and the child's issue. In 1983, Grantor's spouse also established a separate irrevocable trust for the benefit of the same child and issue. The terms of the spouse's trust and Grantor's trust are identical. In 2002, the appropriate local court approved the merger of the two trusts into one trust to save administrative costs and enhance the management of the investments. The merger of the 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 merger. In addition, the merger 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 that resulted from the merger will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

In the present case, Trust 1 and Trust 2 were established on Date 1 and Date 2, respectively. Date 1 and Date 2 are both dates prior to September 25, 1985. Trust 1 and Trust 2 are both considered irrevocable because neither § 2038 nor § 2042 apply. Further, it is represented that there have been no additions made to Trust 1 or Trust 2 after September 25, 1985. Accordingly, Trust 1 and Trust 2 are currently exempt from the GST tax under § 26.2601-1(b)(1).

Based on the facts submitted and the representations made, the proposed merger of Trust 1 into Trust 2 will not result in a shift of any beneficial interest in the trusts to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the merger. Further, the proposed merger will not extend the time for vesting of any beneficial interest beyond the period originally provided for under the terms of the original trusts. Accordingly, the proposed merger will not affect the grandfathered status of the trusts and will not cause any distributions from the merged trusts or distributions upon termination of the merged trusts to become subject to the GST tax, provided there are no post-merger additions to the merged trusts.

Ruling Request 3:

Section 2501(a)(1) provides, generally, that a tax is imposed on the transfer of property by gift by any individual, resident or nonresident.

Section 2511(a) provides that the tax imposed by § 2501 shall 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.

In the present case, the interests of the beneficiaries before and after the proposed merger are identical. Accordingly, the proposed merger of Trust 1 into Trust 2 will not cause taxable gifts to be made under § 2511.

Ruling Request 4:

Section 61 of the Internal Revenue Code provides that gross income means all income from whatever source derived. 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 therefrom 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(b) provides 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.

Section 1001(c) provides that, except as otherwise provided in subtitle A, the entire amount of the 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 as loss sustained.

An exchange of property results in the realization of gain or loss under § 1001 if the properties are materially different. Cottage Savings Assoc. v. Commissioner, 499 U.S. 554 (1991). Properties exchanged are materially different if the properties embody legal entitlements "different in kind or extent" or if the properties confer "different rights and powers." Id. at 565. In Cottage Savings, the Supreme Court held that mortgage loans made to different obligors and secured by different homes embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans. Id. In defining what constitutes a "material difference" for purposes of § 1001(a), the Court states 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. Id. at 564-65.

In the present case, the issue is whether the beneficiaries of the successor trust would have the same property interests and legal entitlements as a result of the proposed merger. According to the taxpayer, the terms and conditions of each merged trust are substantially identical to the terms and conditions of the successor trust. Because the property interests and legal entitlements of the beneficiaries will remain unchanged by the proposed merger, it would be consistent with Cottage Savings to find that the beneficiaries' interests after the proposed merger will not differ materially from the beneficiaries' interests before the proposed merger. Thus, the proposed merger would not result in the realization of any gain or loss or other taxable event under § 61 or § 1001 to either the beneficiaries or the trusts.

Ruling Request 5:

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 by 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, in part, 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 the taxpayer's hands as it would have in the hands of such other person.

Based upon the information submitted and representations made, we conclude that because § 1001 does not apply to the proposed merger, under § 1015, the basis of the assets held by the successor trust will be the same as the basis of those assets currently held by Trust 1 and Trust 2 prior to the merger. Furthermore, under § 1223(2), the holding period of the assets in the successor trust will include the holding period of the assets in Trust 1 and Trust 2 prior to the merger.

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. In addition, no opinion is expressed or implied with respect to the income tax consequences of any transaction.

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 Corporate Trustee.

Sincerely,

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

Enclosure:
Copy for section 6110 purposes