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Washington, DC 20224

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CC:PSI:B04 – PLR-116240-04

Date: NOVEMBER 22, 2004

In Re:

Legend:

Date 1 =
Settlor =
Trust 1 =

Trust 2 =

Trust 3 =

Son 1 =

Son 2 =

Son 3 =
Charity 1 =
Charity 2 =
State =
Company =

Individual 1 =
Individual 2 =
Charity 3 =

Charity 4 =

State --------=

State Statute =
S Trust 1 =
S Trust 2 =
S Trust 3 =
Grandchild 1=
Grandchild 2=

Grandchild 3=

Great Grandchild 1=

Great Grandchild 2=

Great Grandchild 3=

Great Grandchild 4=

Great Grandchild 5=

Dear :

This is in response to a letter dated March 17, 2004, and other correspondence, requesting rulings regarding the income, gift, and generation-skipping transfer (GST) tax consequences of a proposed merger of trusts.

Facts

The facts submitted and representations made are as follows. On Date 1, Settlor created three irrevocable trusts, Trust 1, Trust 2, and Trust 3 ("Trusts"), named for Settlor's three sons, Son 1, Son 2, and Son 3, respectively. The terms of Trusts are identical except that the initial income beneficiary of each Trust is the child of Settlor for whom the trust is named. No additions, actual or constructive, have been made to Trusts since September 25, 1985.

Article Third of each Trust provides that the trust will terminate and all interests will vest 21 years after the date of the death of the last survivor of Settlor, Son 1, Son 2, and Son 3. Of these individuals, only Son 1 is now living.

Article Fourth, Section I of each Trust provides for distribution or accumulation of the trust income until the termination date as follows:

> A. Subject to the discretionary power in the Trustees to accumulate net income and to pay over a part of the net income for charitable purposes as hereinafter provided, the Trustees shall pay over and distribute the entire net income from the corpus of the Trust Estate to [Son for whom trust is named] so long as he shall live, such payments of income to be at such intervals as the Trustees and the beneficiary agree upon but not less often than annually.
>
> B. Subject to the discretionary power in the Trustees to accumulate net income and to pay over a part of the net income for charitable purposes as hereinafter provided, the Trustees shall, upon the death of [Son for whom trust is named], pay over and distribute the entire net income from the Trust Estate in equal shares to the Grantor's grandchildren from time to time living, the issue of a deceased grandchild to take such grandchild's share, per stirpes. The terms "grandchild" or "grandchildren" wherever used in this Agreement shall include only the children of the body [Son 1, Son 2, and Son 3.]
>
> C. So long as one or more non-beneficiary Trustees are acting hereunder, such non-beneficiary Trustee or Trustees may in his or their sole discretion accumulate a part or all of the net income otherwise payable to [Son for whom trust is named] for and during his lifetime but not beyond the period authorized by the law of the [State] as it exists from time to time during the existence of this Trust. The decision to accumulate income and the accumulation of such income shall be subject to question by no beneficiary whatsoever. Any income so accumulated shall be added to and become a part of the corpus from which such income was derived and shall thereafter for all purposes be considered as a part of the corpus of the Trust Estate, the income therefrom to be treated in all respects like other income from the corpus of the Trust Estate.
>
> D. The Trustees may in their sole discretion pay to or permanently set apart for charities in any year a sum not to exceed twenty per centum (20%) of such year's net income from the entire Trust Estate. The charity or charities to receive any such payment or payments shall be selected by the Trustees from time to time.

Article Fourth, Section II of each Trust provides that upon termination of the trust and vesting of all interests, the trustees must distribute the trust estate, including any income accrued or accumulated, to Settlor's grandchildren in equal shares, per capita, the then living issue of a deceased grandchild to take, per stirpes, the share such deceased grandchild would have received. (Under Article Fourth, Section III, the trustees will retain in a vested trust the share of any beneficiary under age 21.) In the event of a total failure of beneficiaries, the trustees will distribute the remaining trust corpus and income equally between Charity 1 and Charity 2. Should either charity not be in existence, the trustees will distribute the remaining trust corpus and income to the remaining charity; if neither is then in existence, the trustees will choose one or more institutions of similar kind and distribute the remaining trust to them.

Trusts contain no definition of the terms "charity" and "charities" and do not limit permissible charities to those described in § 170 of the Internal Revenue Code.

Under Article Fourth, Section VI of each Trust, the non-beneficiary trustees have full power and authority at any time and from time to time to pay over to the beneficiary then entitled to receive income such sums from the corpus of the trust as such trustees in their sole discretion deem necessary or advisable and in the best interests of the beneficiary. Such trustees may, instead of encroaching on corpus for such purposes, charge any such advances against future income. Any encroachment upon corpus must be made against the trust estate as a whole without any attempt to allocate the share of any particular beneficiary, but advances of future income must be charged to the beneficiary receiving the advance so far as it is possible to do so.

Article Fifth provides that the trustees shall have every power and authority given and granted to trustees by law to do, with respect to the management of the trust estate." Article Ninth provides that State is the situs of trust and that the laws of State apply. Under State Statute, a trustee has the power "to consolidate 2 or more trusts having substantially similar terms into a single trust." No court or third party approval is required.

The primary asset of each Trust is stock in Company which is currently taxed as a C corporation. The shareholders of Company want to elect S corporation status for Company. All of Company's shareholders must be eligible to hold S corporation stock as of the first day of the year in which the election will take effect.

Individual 1 and Individual 2 are currently serving as the trustees of Trusts and are not beneficiaries of Trusts. The trustees want to make an electing small business trust (ESBT) election under § 1361(a) for each of Trusts 1, 2, and 3 to qualify each trust as an eligible S corporation shareholder. However, the trustees believe that Trusts are not currently eligible to make this election because (1) the discretionary power in the trustees to pay up to 20 percent of each Trust's annual income to one or more charities contains no limit on the number of charities, and (2) the trust agreement does not limit permissible charities to those described in § 170.

Individual 1, in his individual capacity, will execute three new trust agreements creating S Trust 1, S Trust 2, and S Trust 3, (the "S Trusts") which will contain provisions substantially similar to those of Trust 1, Trust 2, and Trust 3, respectively. Individuals 1 and 2 will be named as the trustees of the S Trusts. Upon their creation, Individual 1 will fund each new S Trust with a nominal sum.

The terms of S Trusts will differ from those of Trusts as follows:

Article Fourth, Section I, Paragraph D. of each S Trust provides:

> D. The Trustees may in their sole discretion pay to or permanently set apart for "Designated Charities" in any year a sum not to exceed twenty per centum (20%) of such year's net income from the entire Trust Estate. The "Designated Charities" to receive any such payment or payments shall be either or both of [Charity 3 and Charity 4], as selected by the Trustees from time to time; except that (1) no payments may be made to or permanently set apart for any charity that is not a "qualified charity" at the time the payment is made or set apart; and (2) any payment made to or permanently set apart for [Charity 4] must be made to or set apart for a Donor Advised Fund under [Charity 4] with the Trustees hereunder as the Advisers as to such Fund. If any Designated Charity is not a qualified charity at any time a payment is to be made or permanently set apart, the Trustees shall designate irrevocably in a written instrument filed with the trust records a substitute qualified charity as a Designated Charity in its place from that point on. "Qualified charity" means a charity that is in existence and is described in Section 170(c)(2) of the Internal Revenue Code of 1986, as amended (or any successor provision).

Charity 4 can make distributions to a broad class of other charities and generally will follow the recommendations of the Advisers.

Article Fourth, Section II of each S Trust remains substantially identical to the original Article Fourth, Section II of each Trust but provides that if either Charity 1 or Charity 2 not be a qualified charity at the time of distribution under Article Fourth, Section II, the trustees will distribute the remaining trust corpus and income to the remaining of said charities that is a qualified charity; if neither is then a qualified charity, the trustees will choose one or more institutions that are then qualified charities of similar kind and distribute the remaining trust to them.

Article Ninth of each S Trust remains substantially identical to the original Article Ninth of each Trust but further provides that each S Trust is governed by the laws of State as if the S Trust agreement were entered into on Date 1.

Shortly after S Trusts are executed, the trustees of Trusts will merge each Trust named for a son of Settlor into the S Trust named for that son. The trustees will

execute a Memorandum of Merger to effectuate the merger of each Trust into the respective S Trust pursuant to their authority under State Statute. After the merger, all of the assets of each Trust, including the Trust's stock in Company, will be owned by the respective S Trust; and Trusts 1, 2, and 3 will cease to exist.

Son 1 is the current income beneficiary of Trust 1. The following individuals are currently receiving income from Trusts 2 and 3 and are the contingent income beneficiaries of Trust 1 at Son 1's death: Grandchild 1, Grandchild 2, Grandchild 3, Great Grandchild 1, Great Grandchild 2, Great Grandchild 3, Great Grandchild 4, and Great Grandchild 5.

The trustees have requested the following rulings:

1. The merger of each Trust named for a son of Settlor into the S Trust named for that son will not subject the assets of Trusts held by S Trusts to GST tax under § 2601 by forfeiting the effective date exempt status of those assets.

2. The merger of each Trust named for a son of Settlor into the S Trust named for that son will not result in a transfer by any of the beneficiaries that is subject to gift tax under § 2501.

3. No gain or loss under § 1001 will be realized by Trusts, S Trusts, or any beneficiaries as a result of the mergers of Trusts into S Trusts, and the assets transferred from each Trust to the respective S Trust will have the same basis and holding periods under §§ 1015 and 1223 before and after the mergers.

4. Immediately after the mergers of Trusts into S Trusts, each S Trust will qualify as an ESBT within the meaning of § 1361(e) and will not have as a potential current beneficiary any charity other than those named in each of the S Trusts.

<u>Ruling Request #1</u>:

Section 2601 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, 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 Tax Reform Act and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to a 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 26.2601-1(b)(4)(i) 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 will not cause the trust to lose its exempt status. The regulation provides that the rules contained in the paragraph 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) provides that a modification 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. 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. 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.

Example 6 contained in § 26.2601-1(b)(4)(i)(E), considers a situation where, 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.

In the present case, Trusts were irrevocable on September 25, 1985. It is represented that no additions, actual or constructive, were made to Trusts after that date.

The merger of each Trust named for a son of Settlor into an S Trust named for that Son is substantially similar to the situation described in Example 6 of § 26.2601-1(b)(4)(i)(E). Each S Trust contains substantially the same provisions as each Trust, except for limiting the definition of permissible charitable beneficiaries to those described in § 170(c)(2) and limiting the number of charitable beneficiaries to two. The trustees of S Trusts will have the same discretion as Trusts to pay or permanently set

aside for charities in any year up to 20 percent of each S Trust's income for the year. Each S Trust will terminate on the same date on which each Trust would have terminated. All interests under S Trusts will vest on the same date as under Trusts. Thus, the merger of Trusts into S Trusts will not result in a shift of any beneficial interest in the trust assets to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the reorganization and will not extend the time for vesting of any beneficial interest in S Trusts beyond the period provided for in Trusts.

The modification in S Trusts will not result in any shift in the beneficial interests in trust to lower generation beneficiaries.

Accordingly, based on the facts submitted and the representations made and assuming the transaction is carried out, and is effective, under State law, we rule that the merger of each Trust named for a son of Settlor into the S Trust named for that son will not subject the assets of Trusts held by S Trusts to GST tax under § 2601 by forfeiting the effective date exempt status of those assets.

Ruling Request #2:

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. Section 2512(b) provides that where property is transferred for less than an adequate consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration is deemed a gift.

In this case, the terms of Trusts and S Trusts are substantially identical (except as noted above). Based on the facts submitted and the representations made and assuming the transaction is carried out, and is effective, under State law, we conclude that the merger of Trusts into S Trusts will not result in a transfer by any of the beneficiaries that is subject to federal gift tax under § 2501.

Ruling Request #3:

Section 61(a)(3) provides that gross income includes gains derived from dealings in property and, under § 61(a)(15), from an interest in a trust.

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 § 1011 for determining loss over the amount realized.

Section 1001(b) states 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 (other than money) received. Under § 1001(c), 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 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 loss sustained.

A partition of jointly owned property is not a sale or other disposition of property where the co-owners of the joint property sever their joint interests but do not acquire a new or additional interest as a result of the transaction. Thus, neither gain nor loss is realized on a partition. See Rev. Rul. 56-437, 1956-2 C.B. 507.

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 of the United States 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 so long as 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 did embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans. Cottage Savings, 499 U.S. at 566.

Under State law, the trustee has the power to "consolidate 2 or more trusts having substantially similar terms into a single trust." See State Statute.

It is consistent with the Supreme Court's opinion in Cottage Savings to find that the interests of the beneficiaries of the S trusts will not differ materially from their interests in Trusts. In the proposed transactions, Trusts will be merged into S Trusts in accordance with State law. Except for the changes described above, all other

provisions of Trusts will remain unchanged. Accordingly, the proposed transaction will not result in a material difference in kind or extent of the legal entitlements enjoyed by the beneficiaries.

Section 1015 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. The basis in the assets of S Trusts will be determined under § 1015.

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 1 of the Code such property has, for the purposes 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 on the facts submitted and the representations made and assuming the transaction is carried out, and is effective, under State law, we conclude that no gain or loss under § 1001 will be realized by Trusts, S Trusts, or any beneficiaries as a result of the mergers of Trusts into S Trusts, and the assets transferred from each Trust to the respective S Trust will have the same basis and holding periods under §§ 1015 and 1223, respectively, before and after the mergers.

Ruling Request #4:

Section 1362(a) provides that, except as provided in § 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1361(b)(1) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and that does not (A) have more than 75 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2)), or an organization described in § 1361(c)(6)) who is not an individual.

Section 1361(c)(2)(A)(v) provides that, for purposes of § 1361(b)(1)(B), an ESBT may be a shareholder of an S corporation. Section 1361(c)(2)(B)(v) provides that in the case of an ESBT, each potential current beneficiary of such trust shall be treated as a shareholder for purposes of § 1361(b)(1); except that, if for any period there is no potential current beneficiary of such trust, such trust shall be treated as the shareholder during such period.

Section 1361(e)(1)(A) defines a trust as an ESBT if (i) such trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, (III) an organization described in paragraph (2), (3), (4), or (5) of § 170(c), or (IV) an organization described in § 170(c)(1) which holds a contingent interest in such trust and is not a potential current beneficiary, (ii) no interest in such trust was acquired by purchase, and (iii) an election under § 1361(e) applies to such trust.

Section 1361(e)(1)(B) provides that the term “electing small business trust” shall not include – (i) any qualified subchapter S trust (as defined in § 1361(d)(3)) if an election under § 1361(d)(2) applies to any corporation the stock of which is held by such trust, (ii) any trust exempt from tax under subtitle A of chapter 1, and (iii) any charitable remainder annuity trust or charitable remainder unitrust (as defined in § 664(d)).

Section 1361(e)(2) provides that, for purposes of § 1361(e), the term “potential current beneficiary” means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust.

Section 1.1361-1(m)(4)(i) provides that, in general, for purposes of determining whether a corporation is a small business corporation within the meaning of § 1361(b)(1), each potential current beneficiary of an ESBT generally is treated as a shareholder of the corporation. Subject to the provisions of § 1.1361-1(m)(4), a potential current beneficiary generally is, with respect to any period, any person who at any time during such period is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust. A person is treated as a shareholder of the S corporation at any moment in time when that person is entitled to, or in the discretion of any person may receive a distribution of principal or income of the trust.

Based on the facts submitted and the representations made and assuming the transaction is carried out, and is effective, under State law, we conclude as follows:

Immediately after the mergers of Trust 1 into S Trust 1, Trust 2 into S Trust 2, and Trust 3 into S Trust 3, if the trustees make valid ESBT elections for S Trust 1, S Trust 2, and S Trust 3, then S Trust 1, S Trust 2, and S Trust 3 will qualify as ESBTs within the meaning of § 1361(e) and will not have as a potential current beneficiary any charity other than those named in S Trust 1, S Trust 2, and S Trust 3.

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

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.

Sincerely yours,

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Lorraine E. Gardner
Senior Counsel, Branch 4
Office of Associate Chief Counsel
(Passthroughs and Special
Industries)

Enclosure
Copy for section 6110 purposes

cc: