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Department of the Treasury
Washington, DC 20224

Person To Contact:
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Refer Reply To:
CC:PSI:B04 – PLR-116224-04
Date: NOVEMBER 22, 2004

In Re:

Legend:

Date 1 =
Settlor =
Trust =

Son =
Trust Agreement =

Granddaughter =

Charity 1 =
Charity 2 =
Charity 3 =

State =
Company =
Individual 1 =

Individual 2 =
Charity 4 =

Charity 5 =

State =
State Statute =
S Trust Agreement =
S Trust =
Grandchild 1 =

Grandchild 2 =

Grandchild 3 =

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 executed Trust Agreement, creating an irrevocable trust. Under Paragraph 2. of Trust Agreement, the irrevocable trust was to be held for the benefit of Settlor's Son during his lifetime. Under Paragraph 3., at Son's death, the trustees were to divide and allocate the remaining trust assets per stirpes among Son's then living descendants. Each share of the trust assets so allocated to a descendant of Settlor was to be retained in trust as a separate and independent trust fund designated by that descendant's name. Settlor and Son are both deceased. Son had one natural born child, Granddaughter. Thus, under Paragraph 3. of Trust Agreement, at Son's death, the trustees placed the remaining trust assets in a single trust named for Granddaughter and held for the benefit of Granddaughter and her descendants (Trust).

No additions, actual or constructive, have been made to the irrevocable trust held under Trust Agreement since September 25, 1985.

Paragraph 4. of Trust Agreement provides as follows:

> 4. After the death of [Settlor's] said son the income and principal of the separate funds named for descendants of [Settlor] created [by Paragraph 3.]

or by the subsequent provisions of this paragraph shall be held and disposed of as follows:

(a) The trustees shall pay to each beneficiary for whom a fund held hereunder is named and his or her descendants, or any one or more of them, so much or all of the net income and principal of such fund, (even though such payments may result in a complete termination of the trusts hereby created with respect to such fund) at such time or times and in such proportions among them as the trustees in their sole discretion shall decide, taking into consideration the character, habits, experience, needs, best interests and welfare of such beneficiary and his or her descendants in the order named and as a group, including the desirability of augmenting their respective individual incomes or assets, their respective abilities to conserve, manage and control property and money usefully and prudently, and all other circumstances and factors which the trustees consider pertinent. Any net income from any such fund not so distributed shall be accumulated and from time to time added to the principal from which it was derived except that the trustees in any calendar year, if they consider that the payments contemplated above will not be jeopardized, in their sole discretion may pay for such religious, charitable, scientific, literary or educational purpose or purposes as the trustees may select such amounts from the net income which otherwise would have been accumulated as the trustees shall deem advisable, but payments pursuant to this sentence shall not exceed twenty per cent of the total net income from such fund for such year.

(b) When each such beneficiary for whom a fund held hereunder is named other than a grandchild of [Settlor] reaches the age of thirty years, the trustees shall distribute to such beneficiary the remaining principal of such fund.

(c) Upon the death of any such beneficiary for whom a fund held hereunder is named, the trustees shall divide and allocate the principal of such fund, together with all accrued or undistributed income therefrom, per stirpes among his or her then living descendants, if any, otherwise per stirpes among the then living descendants of the nearest lineal ancestor of such beneficiary who also was a descendant of [Settlor] and of whom one or more descendants then are living, or if none, then per capita among such of [Settlor's] grandchildren as then are living, the then living descendants of any grandchild of [Settlor] who then is deceased being allocated per stirpes the share which would have been allocated to such deceased grandchild of [Settlor] if then living. Each share so allocated to a descendant of [Settlor] for whom a fund then held hereunder is named shall be added to such

> fund and each share so allocated to any other descendant of [Settlor] shall be retained in trust hereunder as a separate and independent trust fund designated by his or her name and disposed of as provided in this instrument.

Paragraph 5. provides that no trust property administered under Trust Agreement will be retained in trust for more than 21 years after the last to die of Settlor's descendants who were living at the execution of Trust Agreement, and each fund still retained in trust at the end of that period will be immediately distributed to the person for whom the fund is named.

Paragraph 6. provides that any interest in the income or principal of the trust property or of any separate fund that is not effectively disposed of by any of the foregoing provisions will be distributed in equal shares to Charity 1, Charity 2, and Charity 3.

Paragraph 9., provides that the trustees have the powers and rights enumerated in that paragraph in addition to those vested in them elsewhere in the instrument or by law. Paragraph 19. 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." It is represented that no court or third party approval is required.

Trust Agreement contains no definition of the terms "charity" and "charities" and does not limit permissible charities to those described in § 170 of the Internal Revenue Code.

Trust holds 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 Trust to qualify Trust as an eligible S corporation shareholder. However, the trustees believe that Trust is not currently eligible to make this election because (1) the discretionary power in the trustees under Trust Agreement to pay up to 20 percent of Trust's annual income to one or more charities contains no limit on the number of charities, and (2) Trust Agreement does not limit permissible charities to those described in § 170.

Individual 1, in his individual capacity, will create S Trust, named for Granddaughter and held for the benefit of Granddaughter and her descendants. Individual 1 will execute a new S Trust Agreement which contains provisions substantially similar to those of Trust Agreement to S Trust Agreement and provides

that only one trust is currently held under its provisions, S Trust. Individuals 1 and 2 will be named as the trustees of S Trust. Upon the creation of S Trust, Individual 1 will fund S Trust with a nominal sum.

The substantive terms of S Trust Agreement will differ from those of Trust Agreement as follows:

Paragraph 4. (a) of S Trust Agreement provides:

> (a) The trustees shall pay to each beneficiary for whom a fund held hereunder is named and his or her descendants, or any one or more of them, so much or all of the net income and principal of such fund, (even though such payments may result in a complete termination of the trusts hereby created with respect to such fund) at such time or times and in such proportions among them as the trustees in their sole discretion shall decide, taking into consideration the character, habits, experience, needs, best interests and welfare of such beneficiary and his or her descendants in the order named and as a group, including the desirability of augmenting their respective individual incomes or assets, their respective abilities to conserve, manage and control property and money usefully and prudently, and all other circumstances and factors which the trustees consider pertinent. Any net income from any such fund not so distributed shall be accumulated and from time to time added to the principal from which it was derived except that the trustees in any calendar year, if they consider that the payments contemplated above will not be jeopardized, in their sole discretion may pay to such “Designated Charities” as the trustees may select such amounts from the net income which otherwise would have been accumulated as the trustees shall deem advisable, but payments pursuant to this sentence shall not exceed twenty per cent of the total net income from such fund for such year. The “Designated Charities” to receive any such payment or payments shall be either or both of [Charity 4] or [Charity 5], as selected by the trustees from time to time; except that (1) no payments may be made to any charity that is not a “qualified charity” at the time the payment is made; and (2) any payment made to [Charity 5] must be made to a Donor Advised Fund under such Program 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, 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 5 can make distributions to a broad class of other charities and generally will follow the recommendations of the Advisers.

Paragraph 5. of S Trust Agreement remains substantially similar to Paragraph 5. of Trust Agreement and provides that no trust property administered under S Trust Agreement will be retained in trust for more than 21 years after the last to die of Settlor's descendants who were living on Date 1, the date Trust Agreement was executed, and each fund still retained in trust at the end of that period will be immediately distributed to the person for whom the fund is named.

Paragraph 6. of S Trust Agreement remains substantially identical to Paragraph 6. of Trust Agreement but further provides that if Charity 1, Charity 2, or Charity 3 is not a qualified charity at the time of distribution under Paragraph 6., the trustees will distribute the remaining trust corpus and income to the remaining of said charities that is a qualified charity; if none of them 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.

Paragraph 19. of S Trust Agreement remains substantially identical to Paragraph 19. of Trust Agreement but further provides that each trust created under S Trust Agreement is governed by the laws of State as if S Trust agreement were entered into on Date 1.

Shortly after S Trust Agreement is executed creating S Trust, the trustees of Trust will merge Trust into S Trust. The trustees will execute a Memorandum of Merger to effectuate the merger pursuant to their authority under State Statute. After the merger, all of the assets of Trust, including Trust's stock in Company, will be owned by S Trust; and Trust will cease to exist.

The current individual beneficiaries of Trust are Granddaughter and her three children, Grandchild 1, Grandchild 2, and Grandchild 3.

The trustees have requested the following rulings:

1. The merger of Trust into S Trust will not subject the assets of Trust held by S Trust to GST tax under § 2601 by forfeiting the effective date exempt status of those assets.

2. The merger of Trust into S Trust 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 Trust, S Trust, or any beneficiaries of either trust as a result of the merger of Trust into S Trust, and the assets transferred from Trust to S Trust will have the same basis and holding periods under §§ 1015 and 1223 before and after the merger.

4. Immediately after the merger of Trust into S Trust, 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 S Trust.:

Ruling Request #1

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, Trust was irrevocable on September 25, 1985. It is represented that no additions, actual or constructive, were made to Trust after that date.

The merger of Trust into S Trust is substantially similar to the situation described in Example 6 of § 26.2601-1(b)(4)(i)(E). S Trust Agreement, governing S Trust, contains substantially the same provisions as Trust Agreement, governing Trust, except for limiting the definition of permissible charitable beneficiaries to those described in § 170(c)(2) and limiting the number and type of charitable beneficiaries. The trustees of S Trust will have the same discretion as they had over Trust to pay or permanently set aside for charities in any year up to 20 percent of S Trust's income for the year. S Trust will terminate on the same date on which Trust would have terminated. All interests under S Trust will vest on the same date as under Trust. Thus, the merger of Trust into S Trust 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 Trust beyond the period provided for in Trust.

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 Trust into S Trust will not subject the assets of Trust held by S Trust 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 Trust Agreement, governing Trust, and of S Trust Agreement, governing S Trust, 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 Trust into S Trust 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 trust will not differ materially from their interests in Trust. In the proposed transaction, Trust will be merged into S Trust in accordance with State law. Except for the changes described above, all other provisions of Trust 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 the S Trust 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 Trust, S Trust, or any beneficiaries as a result of the merger of Trust into S Trust, and the assets transferred from Trust to 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 merger of Trust into S Trust, if the trustees make a valid ESBT election for S Trust, then 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 S Trust.

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
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cc: