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Person To Contact: _____, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B04
PLR-133358-07
Date: DECEMBER 26, 2007

In Re:

Legend

- Settlor =
- LLC =

- Date 1 =
- Date 2 =
- Date 3 =
- Date 4 =
- Date 5 =
- Date 6 =
- Date 7 =
- Date 8 =
- Trust =
- V =
- W =
- X =
- Y =
- Z =
- Year 1 =
- Year 7 =
- Trustee =
- Trust 1 =

Trust 2 =
Court =
State Statute 1 =
State Statute 2 =

Dear :

This is in response to a letter dated September 11, 2007, and prior correspondence from your authorized representative, requesting rulings on the income and generation-skipping transfer (GST) tax consequences of the proposed division and modification of a trust.

Facts

On Date 1, as amended on Date 2 and Date 3, Settlor established Trust for her benefit during her lifetime and, after her death, for the benefit of her lineal descendants and their spouses, widows, or widowers. Trust became irrevocable at Settlor's death on Date 4, a date prior to September 25, 1985. It is represented that no additions have been made to Trust subsequent to that date.

Under the terms of Trust, Trustee, in its sole discretion, may distribute income and principal in equal or unequal proportions for the support, maintenance, comfort and happiness of the beneficiaries. Any income not distributed will be accumulated and added to the principal annually. As of Date 5, Settlor had V living lineal descendants or spouses of lineal descendants. Trust terminates 21 years after the death of the last survivor of two of Settlor's brothers, her husband, her lineal descendants, and the husbands, wives, widows, or widowers of any of her lineal descendants living at the creation of Trust. There are currently W lineal descendants and one widow of a lineal descendant who were living when Trust was created on Date 1 and are still living. Upon termination of Trust, the assets will be distributed to the then living beneficiaries in equal or unequal portions in Trustee's sole discretion.

Trust owns approximately Z % of the outstanding units in LLC. LLC plans to elect to be treated as an S corporation effective Date 8. In order to make the election, all of LLC's members, including Trust, must be eligible shareholders as defined in § 1361(b)(1)(B). Accordingly, Trust must be eligible to make a valid Electing Small Business Trust (ESBT) election which requires that all of the potential current beneficiaries of Trust must be either United States citizens or residents. As of Date 5, Trust had V persons who could be considered potential current beneficiaries and some of these beneficiaries are nonresident aliens. From Year 1 through Year 7, Trustee made annual distributions from Trust to X beneficiaries, of which Y are nonresident aliens. The spouses and the lineal descendants of the Y beneficiaries are also nonresident aliens. LLC represents that but for the fact that Y beneficiaries are nonresident aliens; Trust would otherwise qualify to be an ESBT.

On Date 6, Trustee filed a petition for division and modification of Trust with Court. The petition requests that Trust be split into two trusts (Trust 1 and Trust 2), Trust 1 holding only LLC units (ESBT Trust) and Trust 2 holding all other Trust assets (non-ESBT Trust). The beneficiaries of the new trusts will be the same as the beneficiaries of Trust. Trustee would remain Trustee of both Trusts. The terms and conditions of the new trusts will be the same as Trust except for a modification to Trust 1. After the modification, Trust 1 will provide that no nonresident alien, as described in § 7701(b)(1)(B), or any successor statute, who may otherwise be a beneficiary of the trust shall be entitled to, nor in the discretion of any person may receive, a distribution from the principal or income of Trust 1 for so long as (1) the trust shall have in effect an election to be taxed as an ESBT pursuant to §1361(e), or any successor statute, and (2) a nonresident alien is not permitted to be a potential current income beneficiary of an ESBT under applicable provisions of the Internal Revenue Code or Treasury Regulations. Therefore, after the modification of Trust 1, the only potential current beneficiaries of Trust 1 will be U.S. citizens. In addition, Trustee has stated it intends to make discretionary distributions from the new trusts in amounts comparable in total to what the beneficiaries would have received from Trust. The beneficiaries currently receiving trust distributions were notified of and consented to the petition. On Date 7, Court approved the petition. Court's ruling is conditioned upon the receipt of favorable rulings from the Service.

Pursuant to State Statute 1, a trustee may divide a trust into two or more separate trusts, if the result does not impair the rights of any beneficiary or adversely affect achievement of the purposes of the trust. State Statute 2 provides that upon division of a trust, a trustee may make distributions in divided or undivided interests or allocate particular assets in proportionate or disproportionate shares.

You have requested the following rulings:

1. The proposed division of Trust will not (i) cause a beneficial interest to be shifted to a beneficiary who occupies a generation lower than the beneficiaries who hold the interests prior to the division; and (ii) extend the time for vesting of any beneficial interest in Trust 1 or Trust 2 beyond the period provided for currently in the Trust.
2. The proposed division of Trust into Trust 1 and Trust 2, in accordance with Court's order authorizing division of Trust and modification of Trust 1 to prohibit distributions to nonresident alien beneficiaries as long as nonresident aliens are not permissible current beneficiaries of an ESBT or as long as Trust 1 holds S corporation stock, will result in Trust 1 being eligible to elect ESBT status under § 1361(e)(1).
3. The proposed division of Trust into Trust 1 and Trust 2 will not result in recognition of gain to any trust or beneficiary pursuant to §§ 61 or 1001.

ISSUE 1

Section 2601 of the Internal Revenue Code imposes a tax on each generation-skipping transfer. Under section 1433(b)(2)(A) of the Tax Reform Act of 1986 Act and § 26.2601-1(b)(1)(I) of the Generation-Skipping Transfer Tax Regulations, 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 the transfer is 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)(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)(1)(ii)(B) or (C) (relating to property includible in the grantor's gross estate under §§ 2038 and 2042).

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 of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) 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 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.

Trust was irrevocable prior to September 25, 1985, and it is represented that there have been no additions (constructive or otherwise) to Trust after September 25, 1985. Accordingly, Trust is exempt from the generation-skipping transfer tax.

Based on the facts presented and representations made, we conclude that the proposed division of Trust will not shift any beneficial interest in 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 division. In addition, the proposed division of

Trust will not extend the time for vesting of any beneficial interest in Trust 1 or Trust 2 beyond the period provided for in the original trust.

ISSUE 2

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) defines a "small business corporation" as a domestic corporation which is not an ineligible corporation and which does not (A) have more than 100 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, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

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

Section 1.1361-1(m)(4)(i) of the Income Tax Regulations provides that for purposes of determining whether a corporation is a small business corporation within the meaning of § 1361(b)(1), each PCB of an ESBT generally is treated as a shareholder of the corporation. Subject to the provisions of § 1.1361-1(m)(4), a PCB 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.

Section 1.1361-1(m)(1)(ii)(D) provides that a nonresident alien (as defined in § 7701(b)(1)(B)) is an eligible beneficiary of an ESBT. However, if the nonresident alien

is a PCB of the ESBT the S corporation will have an ineligible shareholder and its S corporation election will terminate.

Section 1.1361-1(m)(5)(iii) provides that if a PCB of an ESBT is not an eligible shareholder of a small business corporation within the meaning of § 1361(b)(1), the S corporation election terminates. For example, the S corporation election will terminate if a nonresident alien becomes a potential current beneficiary of an ESBT. Such a potential current beneficiary is treated as an ineligible shareholder beginning on the day such person becomes a potential current beneficiary, and the S corporation election terminates on that date.

Pursuant to § 1.1361-1(m)(4)(iv), a person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event (such as the death of the holder of a power of appointment) is not a potential current beneficiary until such time or the occurrence of such event.

Based solely on the facts and representations submitted, we conclude that the proposed division of Trust into Trust 1 and Trust 2, in accordance with Court's order authorizing the division of Trust and modification of Trust 1 to prohibit distributions to nonresident alien beneficiaries as long as nonresident aliens are not permissible current beneficiaries of an ESBT or as long as Trust 1 holds S corporation stock, will result in Trust 1 being eligible to elect ESBT status under § 1361(e)(1).

ISSUE 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) 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 (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 if 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.

In Rev. Rul. 69-486, 1969 C.B. 159, a non-pro rata distribution of trust property was made in kind by the trustee, although the trust instrument and local law did not convey authority to the trustee to make a non-pro rata distribution of property in kind. The distribution was effected as a result of a mutual agreement between the trustee and the beneficiaries. Because neither the trust instrument nor local law conveyed authority to the trustee to make a non-pro rata distribution, Rev. Rul. 69-486 held that the transaction was equivalent to a pro rata distribution followed by an exchange between the beneficiaries, an exchange that required recognition of gain under § 1001.

Cottage Savings Ass'n v. Commissioner, 499 U.S. 554, (1991), concerns the issue of when a sale or exchange has taken place that results in realization of gain or loss under § 1001. In Cottage Savings, a financial institution exchanged its interests in one group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans. The two groups of mortgages were considered "substantially identical" by the agency that regulated the financial institution.

The Supreme Court in Cottage Savings 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." Cottage Savings, 499 U.S. at 560-61. 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 Statute 1 a trustee may divide a trust into two or more trusts separate trusts if the result does not impair the right of any beneficiary or adversely affect achievement of the purposes of the trust. State Statute 2 provides that upon division of a trust, a trustee may make distributions in divided or undivided interests or allocate particular assets in proportionate or disproportionate shares.

It is consistent with the Supreme Court's opinion in Cottage Savings to find that the interests of the beneficiaries of the new trusts will not differ materially from their interests in Trust. In the proposed transaction, Trust will be divided in accordance with state law and under the trustee's powers. Except for the changes described above, the new trusts will be administered under the same provisions as Trust. Accordingly, based upon the facts presented and representations made, we conclude that the proposed transaction will not result in a material difference in the kind or extent of the legal entitlements enjoyed by the beneficiaries of the trust, and no gain or loss is realized by the beneficiaries or Trust on the division for purposes § 1001(a).

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. Specifically, no opinion is expressed concerning whether LLC is otherwise eligible to be treated as an S corporation or whether Trust is otherwise eligible to be an ESBT.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

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. 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.

Sincerely,

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

Enclosures

Copy for section 6110 purposes