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Department of the Treasury
Washington, DC 20224

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Person To Contact:
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Refer Reply To:
CC:PSI:B09
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Date:
March 18, 2005

In Re:

Legend

Grantor =
Trust =

State Court =

State Statute =
Date 1 =

Dear :

This is in response to your letter dated April 26, 2004, requesting rulings regarding the income, gift, and generation-skipping transfer (GST) tax consequences of severing a trust.

The facts submitted and the representations made are as follows. Prior to September 25, 1985, Grantor formed and funded an irrevocable trust (Trust) for the benefit of her four grandchildren and their lineal descendants. The Trust's terms do not provide the Grantor with a power that would cause the Trust to be included in her gross estate under §§ 2038 or 2042, if the Grantor had died on September 25, 1985. It has been represented that no additions, constructive or otherwise, have been made to the Trust since September 25, 1985.

On Date 1, State Court, pursuant to State Code, issued an order directing that the Trust be divided on a pro-rata basis into four Subtrusts (Subtrusts 1, 2, 3, and 4), one for each of the Grantor's grandchildren and his or her lineal descendants. The order provides that the four Subtrusts will have the same terms as the Trust except that distributions from each Subtrust are to be limited to the grandchild from whom the Subtrust was

formed and the grandchild's lineal descendants. The order is contingent upon the receipt of a favorable private letter ruling.

The following rulings have been requested.

1. The Trust was an irrevocable GST trust on September 25, 1985, and that the proposed division of the Trust into four Subtrusts will not cause the four Subtrusts to lose their exempt status for GST tax purposes under § 2601 of the Code.
2. The distribution of the Trust's assets on a pro-rata basis from the Trust to the four Subtrusts will not be deemed a taxable gift under § 2501.
3. The four Subtrusts will be treated as separate trusts for federal income tax purposes under § 643(f).
4. The distribution of assets from the Trust to the four Subtrusts will not result in the recognition of income under § 61 or the recognition of gain or loss under § 1001 to either the Trust, the four Subtrusts, or any of the individual beneficiaries of the Trust and the four Subtrusts.
5. The assets distributed from the Trust to the four Subtrusts will retain the same tax basis under § 1015 as the assets had in the Trust before the division.
6. The assets distributed from the Trust to the four Subtrusts will retain the same holding period under § 1223(2) as the assets had in the Trust before the division.

Law and Analysis:

Ruling 1:

Section 2601 imposes a tax on every GST (within the meaning of Subchapter B).

Under § 1433(a) of the Tax Reform Act of 1986, the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) 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 cause the trust to be included 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 GST tax will not cause the trust to lose its exempt status.

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.

Section 26.2601-1(b)(4)(i)(E), Example 5, provides as follows. In 1980, Grantor established an irrevocable trust for the benefit of his two children, A and B, and their issue. Under the terms of the trust, the trustee has the discretion to distribute income and principal to A, B, and their issue in such amounts as the trustee deems appropriate. On the death of the last to die of A and B, the trust principal is to be distributed to the living issue of A and B, per stirpes. In 2002, the appropriate local court approved the division of the trust into two equal trusts, one for the benefit of A and A's issue and one for the benefit of B and B's issue. The trust for A and A's issue provides that the trustee has the discretion to distribute trust income and principal to A and A's issue in such amounts as the trustee deems appropriate. On A's death, the trust principal is to be distributed equally to A's issue, per stirpes. If A dies with no living descendants, the principal will be added to the trust for B and B's issue. The trust for B and B's issue is identical (except for the beneficiaries), and terminates at B's death at which time the trust principal is to be distributed equally to B's issue, per stirpes. If B dies with no living descendants, principal will be added to the trust for A and A's issue. The division of the trust into two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the division. In addition, the division does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the two partitioned trusts resulting from the division will not be subject to the provisions of chapter 13.

In the present case, the Trust was irrevocable on September 25, 1985. The Trust's terms do not provide the Grantor with a power that would cause the Trust to be included in her gross estate under §§ 2038 or 2042, if the Grantor had died on September 25, 1985. It is represented that no additions, actual or constructive, have been made to the Trust after September 25, 1985.

The Trust will be divided on a pro-rata basis into four Subtrusts. The Subtrusts will have the same terms as the Trust except that distributions from each Subtrust are to be limited to the grandchild for whom the Subtrust was created and the grandchild's lineal descendants. This change is similar to the changes described in § 26.2601-1(b)(4)(i)(E), Example 5. Therefore, the proposed division of the Trust will not result in a shift of any beneficial interest in the Trust to any beneficiary who occupies a generation

lower than the persons holding the beneficial interests prior to the proposed division and the proposed division will not extend the time for vesting of any beneficial interest in the Trust beyond the period provided for in the Trust.

Accordingly, based on the facts submitted and the representations made, we conclude that the Trust was an irrevocable GST tax trust on September 25, 1985, and that the proposed division of the Trust into four Subtrusts will not cause the four Subtrusts to lose their exempt status for GST tax purposes under § 2601, provided there are no additions, actual or constructive, to the Subtrusts after September 25, 1985.

Ruling 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.

In this case, the interest of each beneficiary will remain the same after the proposed division as it was prior to the division. Accordingly, based on the facts submitted and the representations made, we conclude that the proposed division will not cause any beneficiary to be considered as having made a taxable gift under § 2501.

Ruling 3:

Section 643(f) provides that, under regulations to be prescribed by the Secretary, two or more trusts shall be treated as one trust if (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose of such trusts is the avoidance of federal income tax.

While Subtrusts 1, 2, 3, and 4 will have the same grantor, they will have different primary beneficiaries. Therefore, based on the facts submitted and representations made, we conclude that Subtrusts 1, 2, 3, and 4 will be treated as separate trusts for federal income tax purposes under § 643(f).

Ruling 4:

Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized therefrom over the adjusted basis provided in § 1011

for determining gain, and the loss is the excess of the adjusted basis provided in § 1011 over the amount realized. Section 1001(c) provides that, except as otherwise provided, the entire amount of the gain or loss on the sale or exchange of property is recognized.

Section 1.1001-1(a) of the Income Tax Regulations provides, as a general rule, that except as otherwise provided in Subtitle A, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially in either kind or in extent, is treated as income or as loss sustained.

For purposes of § 1001, in an exchange of property, each party to the exchange gives up a property interest in return for a new or additional property interest. Such an exchange of property is a disposition under § 1001(a). See § 1.1001-1.

Rev. Rul. 56-437, 1956-2 C.B. 507, holds that 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 in order to extinguish their survivorship interests.

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

Based on the facts submitted and the representations made, we conclude that the proposed division of the Trust on a pro-rata basis into four Subtrusts will not cause the interests of the trust beneficiaries to differ materially. The trust beneficiaries will hold essentially the same interests before and after the pro-rata division. Accordingly, the proposed division of the Trust assets among Subtrusts 1, 2, 3, and 4 will not cause the Trust, the four Subtrusts, or any of the individual beneficiaries of the Trust and the four Subtrusts to recognize any gain or loss from a sale or other disposition of property under §§ 61 and 1001.

Ruling 5:

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.

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 a 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 in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer under the law applicable to the year in which the transfer is made.

In this case, based upon the facts submitted and the representations made, we conclude that because neither §§ 61 and 1001 applies to the proposed transaction, the basis of the assets for each of the Subtrusts will be the same as the Trust's basis in the assets before the division.

Ruling 6:

Section 1223(2) provides that, in determining the period for which a 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 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.

In the proposed division of the Trust into four Subtrusts, the tax basis of the four Subtrusts in each property received from the Trust will be the same as the tax basis of the Trust in such property. Accordingly, based upon the facts submitted and the representations made, we conclude that the assets distributed from the Trust to the four Subtrusts will retain the same holding period under § 1223(2) as the assets had in the Trust before the division.

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.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

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,

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

Enclosures: Copy for ' 6110 purposes