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PLR-156643-04

Date:

May 11, 2005

In Re:

Legend

Settlor 1	-
Settlor 2	-
Child A	-
GCA1	-
GCA2	-
Child B	-
GCB1	-
GCB2	-
Child C	-
GCC1	-
GCC2	-
GCC3	-
Trust 1A	-
Trust 1B	-
Trust 1C	-
Trust 2A	-

Trust 2B -

Trust 2C -

Date 1 -

Date 2 -

Date 3 -

Date 4 -

\$A -

\$B -

\$C -

Foundation -

State X -

Dear :

This is in response to your letter of October 8, 2004, and subsequent correspondence, in which you requested rulings with respect to the federal income, gift, and generation-skipping transfer (GST) tax consequences of a proposed modification of six trusts.

On Date 1, Settlor 1 and Settlor 2, who were husband and wife, created three irrevocable inter vivos trusts for the benefit of their three children and their descendants. Trust 1A was established for the benefit of Child A and Child A's descendants, Trust 1B for the benefit of Child B and Child B's descendants, and Trust 1C for the benefit of Child C and Child C's descendants.

On Date 2, Settlor 1 and Settlor 2 created three more irrevocable inter vivos trusts also for the benefit of Child A, Child B, and Child C and their descendants. Trust 2A was established for the benefit of Child A and Child A's descendants, Trust 2B for the benefit of Child B and Child B's descendants, and Trust 2C for the benefit of Child C and Child C's descendants.

The trustees of both Trust 1A and Trust 2A are GCA1 (a child of Child A), an unrelated individual, and an unrelated corporation. The trustees of both Trust 1B and Trust 2B are GCB1, GCB2 (children of Child B) and an unrelated corporation. The trustees of both Trust 1C and Trust 2C are Child C, GCC3 (a child of Child C), and two unrelated individuals.

Settlor 1 and Settlor 2 are both deceased. Child A is deceased and is survived by a spouse, two children (GCA1 and GCA2), three grandchildren, and six great grandchildren (all minors). Child B is deceased and is survived by two children (GCB1 and GCB2), and two grandchildren. Child C is living and has three children (GCC1,

GCC2, and GCC3) and four grandchildren (three of whom are minors). The provisions of all six trusts are governed by the law of State X.

The dispositive provisions of Trusts 1A, 1B, and 1C are contained in Article SECOND of the trusts established on Date 1. Likewise, the dispositive provisions of Trusts 2A, 2B, and 2C are contained in Article SECOND of the trusts established on Date 2.

Trusts 1A and 2A, Trusts 1B and 2B, Trusts 1C and 2C are collectively referred to as the primary trusts for the benefit their primary beneficiaries, Child A, Child B, and Child C, respectively.

Under the terms of Article SECOND of Trusts 1A, 1B, and 1C, if the primary beneficiary of that primary trust dies prior to termination of the trust, survived by a spouse but no surviving descendants, either on the death of the beneficiary or at the termination of the primary trust, the trustee shall pay the lesser of \$C or one-tenth of the trust estate to that surviving spouse. Trusts 2A, 2B, and 2C do not have similar provisions. Otherwise, the dispositive provisions of Trusts 1A, 1B, 1C, 2A, 2B, and 2C are identical, except for the termination date and the identity of the beneficiaries and the trustees. These provisions are summarized as follows:

Each primary trust is created for the benefit of Child A, Child B, and Child C (the primary beneficiaries), and their descendants, respectively. Under the terms of Article SECOND of each trust, during the life of the primary beneficiary (Child A, Child B, and Child C), the trustees of each respective primary trust shall annually distribute \$A to that beneficiary. Such distributions will be first from income and then corpus. Any remaining income may be distributed to each primary beneficiary and/or to their respective descendants in such portions as the independent trustee of each primary trust deems advisable. If the income is not sufficient to meet the needs of the primary beneficiary after taking into account income from all other sources, some or all of the corpus of the primary trust may be distributed to the primary beneficiary as the independent trustee deems necessary for that beneficiary's support or emergency needs.

In the event that the primary beneficiary dies prior to the termination of the trust, without surviving descendants, the net income will be distributed in equal shares for the benefit of the descendants of Settlor 1 and Settlor 2, as the independent trustee deems advisable. Any undistributed income will be accumulated.

Upon the death of the primary beneficiary, if there are surviving descendants of that beneficiary, the primary trust will terminate and the corpus will be divided into equal shares, per stirpes, for each immediate descendant of the primary beneficiary. Each such share will be held in a separate trust, referred to as the secondary trust, for the benefit of that respective descendant and the descendant's issue. Each immediate

descendant of Child A, Child B, and Child C, respectively GCA1, GCA2, GCB1, GCB2, GCC1, GCC2, and GCC3, would be the primary beneficiary of each secondary trust.

Similar to the primary trusts, during the life of the primary beneficiaries of the secondary trusts, the trustees of each secondary trust shall annually distribute \$B to the primary beneficiary of that secondary trust. Such distributions will be first from income and then corpus. Any remaining income may be distributed to the primary beneficiary and/or to their respective descendants in such portions as the independent trustee of each secondary trust deems advisable. Any excess income will be accumulated. If the income is not sufficient to meet the needs of the primary beneficiary after taking into account income from all other sources, some or all of the corpus of the secondary trust may be distributed to that primary beneficiary as the independent trustee deems necessary for that person's support or emergency needs.

In the event that the primary beneficiary of the secondary trust dies prior to the termination of the trust, without surviving descendants, the net income will be distributed in equal shares for the benefit of the descendants of Settlor 1 and Settlor 2, as the independent trustee deems advisable. Any undistributed income will be accumulated.

If the primary beneficiary of the secondary trust dies prior to the termination of that trust with surviving descendants, the net income is to be distributed in such amounts as the trustee deems advisable, per stirpes to or for the benefit of the descendants of that primary beneficiary. Any undistributed income will be accumulated.

Each primary and secondary trust under the trust agreements executed on Date 1 (Trusts 1A, 1B, and 1C), unless terminated earlier under the provisions of the trust, will terminate upon the date of death of the last survivor of all descendants of Settlor 1 and Settlor 2 living on Date 1. The descendants of Settlor 1 and Settlor 2, who were alive when Trusts 1A, 1B, and 1C were established on Date 1 and who are currently living are GCA1, GCA2, GCB1, GCB2, and Child C.

Each primary and secondary trust under the trust agreements executed on Date 2 (Trusts 2A, 2B, and 2C), unless terminated earlier under the provisions of the trust, will terminate 20 years and 11 months after the date of death of the last survivor of all descendants of Settlor 1 and Settlor 2 living on Date 2. The descendants of Settlor 1 and Settlor 2, who were alive on Date 2 when Trusts 2A, 2B, and 2C were established and who are currently living are GCA1, GCA2, GCB1, GCB2, Child C, and GCC1.

The provisions governing the distribution of the trusts on termination are contained in Article Second, Paragraph G of the Date 1 trusts, and Article Second, Paragraph F, of the Date 2 trusts. Upon termination of each primary trust created on Date 1, unless terminated earlier under the provisions of the trust, a specified amount is to be distributed to the surviving spouse of the primary beneficiary, under certain circumstances. After making the payment described above in the case of the Date 1

primary trusts, the trustees of both the Date 1 and Date 2 primary trusts are to make “equalizing distributions” such that all beneficiaries have received equal amounts from the trust prior to final distribution. The remainder of the trust estate is to be distributed in equal shares to the descendants of the primary beneficiary, per stirpes, or if none, in equal shares to the surviving descendants of Settlor 1 and Settlor 2.

Regarding the secondary trusts created on Date 1 and Date 2, upon termination, “equalizing distributions” are to be made under the same terms as provided for in the case of the Date 1 primary trusts. The remainder is to be distributed to the surviving primary beneficiary of the secondary trust, or if the primary beneficiary does not survive termination, to the descendants, per stirpes of the primary beneficiary of the secondary trust, and if no descendants survive, then to the surviving descendants of Settlor 1 and Settlor 2, per stirpes.

Further, in the event there are no descendants of Settlor 1 and Settlor 2 living upon termination of the primary or secondary trusts created on Date 1 (Trusts 1A, 1B, and 1C), the trust estate will be distributed to one or more exempt legal entities (defined under Article Twelfth, Paragraph A (16) as an entity organized and operated exclusively for religious, charitable, scientific, literary or educational purposes under the laws of the United States and State X). The corresponding provisions of Trusts 2A, 2B, and 2C, provide that, in the event there are no descendants of Settlor 1 and Settlor 2 living upon termination of the primary or secondary trusts, the trust estate will be distributed to Foundation. If Foundation is not in existence at that time, the trust estate will be distributed to one or more exempt legal entities, described above.

Article FIFTH of each trust provides that, without intending to limit the investment or discretionary power of the trustees, the settlors suggest that the trustees retain as part of the trust estate, the stock that initially funded each trust and do not sell or dispose of the stock unless, in the judgment of the trustees, such retention would result in permanent or irreparable loss to the trust estate. The settlors also suggest that the trustees invest any cash of the trust estate in obligations issued or guaranteed by the United States.

Child A died on Date 3 and Child B died on Date 4, at which times their respective primary trusts were divided into secondary trusts for the benefit of Child A’s and Child B’s descendants. Child C is still living and the primary trusts created for the benefit of Child C are still in existence. Consequently, there are currently two primary trusts (Trusts 1C and 2C) in existence and eight secondary trusts (two each for the benefit of GCA1, GCA2, GCB1, and GCB2) in existence.

It is represented that Trusts 1A, 1B and 1C and Trusts 2A, 2B and 2C were created and irrevocable before September 25, 1985 and that no additions, actual or constructive, have been made to any of the trusts since September 25, 1985.

The trustees of Trusts 1A, 1B and 1C and Trusts 2A, 2B and 2C propose to file a petition in the appropriate court in State X to modify each trust. Under the terms of the trusts as modified, the beneficiaries of distributions from each trust prior to and upon termination will be limited to the descendants of the initial primary beneficiary of the respective trust, that is, Child A, Child B, or Child C (or if there are no such descendants, to exempt legal entities of Foundation). Thus, the beneficiaries of distributions from the separate secondary trusts created under Trusts 1A and 2A will be limited to the descendants of Child A. The beneficiaries of distributions from the separate secondary trusts created under Trusts 1B and 2B will be limited to the descendants of Child B. The beneficiaries of distributions from the primary trust and separate secondary trusts to be created under Trusts 1C and 2C will be limited to the descendants of Child C.

Specifically, because the primary trust for the benefit of Child C is still in existence, Article SECOND, Paragraph A of the Date 1 Trusts, will be modified to provide that if the primary beneficiary of the primary trust dies prior to the termination date, with no descendants surviving, then the trust will terminate and the trust estate will be distributed pursuant to the dispositive provisions of Paragraph G (discussed below), rather than to the descendants of Settlor 1 and Settlor 2, as is the case under the current terms of the trusts.

Likewise, Article SECOND, Paragraph B of the Date 1 Trusts, will be modified to provide that if the primary beneficiary of a secondary trust dies prior to termination, with no descendants surviving, then the trust income is to be distributed, in such amounts as the trustees deem advisable, to the descendants of the primary beneficiary of the primary trust (Child A, Child B, or Child C, as the case may be) rather than to the descendants of Settlor 1 and Settlor 2 as is the case under the current terms of the trusts. In addition, Article SECOND, Paragraph B will be modified to provide that, if all descendants of the primary beneficiary of the secondary trust and all the descendants of the primary beneficiary of the primary trust die prior to termination, the secondary trust will terminate and the trust estate will be distributed pursuant to the dispositive provisions of Paragraph G.

Paragraph G of Article Second of Trusts 1A, 1B and 1C will be modified to provide that, if any descendant of the primary beneficiary of the primary trust (rather than any descendants of Settlor 1 and Settlor 2) survives the termination, any distributions from the primary or secondary trust will be made, pursuant to the dispositive provisions in Paragraph G, to the descendants of the primary beneficiary of the respective primary trust. Paragraph G will also be modified to provide that, if the primary beneficiary of a secondary trust dies prior to or contemporaneously with termination, leaving no descendants surviving, the trust remainder will be distributed to the descendants of the primary beneficiary of the primary trust, per stripes, rather than to the descendants of Settlor 1 and Settlor 2, as the trusts currently provide. Also, if all the beneficiaries of the primary trust and the secondary trusts die prior to, or at, the

termination date, leaving no descendants of the primary beneficiary of the primary trust, the trust estate will be distributed to one or more exempt legal entities (defined under Article Twelfth, Paragraph A (16) as an entity organized and operated exclusively for religious, charitable, scientific, literary or educational purposes under the laws of the United States and State X).

The corresponding provisions of Trusts 2A, 2B, and 2C, Article Second, Paragraphs B and F will be modified in the same manner as Article Second, Paragraphs A, B and G of Trusts 1A, 1B, and 1C, above, with the one exception; in the event that all descendants of the beneficiary of the primary trust die before or at the termination date, the trust estate will be distributed to Foundation, rather than one or more exempt legal entities.

The trustees further propose to modify Article FIFTH of each trust to include the statement “Nothing herein shall prevent the Trust Estate from being invested in accordance with the [State X prudent investor rule]”.

The petition to the appropriate local court requested that any order issued by the court is contingent based on the Internal Revenue Service issuing a favorable private letter ruling on the issues presented.

The following rulings have been requested:

1. The proposed reformation will not cause any primary trust (Trusts 1A, 1B, 1C, 2A, 2B, or 2C) or secondary trust established under the terms of any primary trust to lose its exemption from the Federal generation-skipping transfer tax.
2. The proposed reformation will not cause any beneficiary of any primary trust (Trusts 1A, 1B, 1C, 2A, 2B, or 2C) or secondary trust established under the terms of any primary trust to have made a gift for Federal gift tax purposes.
3. The proposed reformation will not cause any primary trust (Trusts 1A, 1B, 1C, 2A, 2B, or 2C), any secondary trust established under the terms of any primary trust, or any beneficiary of any primary or secondary trust to recognize gain or loss from the sale or disposition of property under §§ 61 or 1001 for Federal income tax purposes.

LAW and ANALYSIS:

ISSUE 1:

Section 2601 of the Internal Revenue Code imposes a tax on every generation-skipping transfer (GST).

Section 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations provides in part that the GST tax does not apply to any generation-skipping transfer under a trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985. This rule does not apply to a pro rata portion of any generation-skipping transfer under an irrevocable trust if additions are made to the trust after September 25, 1985.

Section 26.2601-1(b)(1)(ii)(A) provides that, except as provided in § 26.2601-1(b)(1)(ii)(B) or (C), any trust (as defined in § 2652(b)) in existence on September 25, 1985, is considered an irrevocable trust.

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 under § 26.2601-1(b) will not cause the trust to lose its exempt status. The regulation provides that the rules contained in the paragraph are generally applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. Except as otherwise provided, 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.

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 § 26.2601-1(b)(4)(i)(D), 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 generation-skipping transfer or the creation of a new generation-skipping 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 5, considers a situation where, 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, Trusts 1A, 1B, 1C, and Trusts 2A, 2B, and 2C were irrevocable on September 25, 1985, and it is represented that no additions, actual or constructive, have been made to any of these trusts or any secondary trust created under the terms of these trusts, after that date. As is the case in §26.2601-1(b)(4)(i)(E), Example 5, the proposed modification restricting the beneficiaries of the primary and secondary trusts to the descendants of the primary beneficiary of the respective primary trust will not result in the shift of beneficial interest in the trust to a beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the division, and will not extend the time for vesting of any beneficial interest. Similarly, the modification providing for the distribution of the trust corpus to either an exempt legal entity or to Foundation, if a trust beneficiary dies with no descendants of the primary beneficiary of the respective primary trust surviving, will not result in the shift of beneficial interest in the trust to a lower generation beneficiary and will not extend the time for vesting of any beneficial interest. Finally, the proposed modification authorizing the trustee to invest in accordance with the State X prudent investor statute will not cause the trusts to lose exempt status.

Therefore, based on the facts submitted and the representations made, we conclude that the reformation of Trusts 1A, 1B, 1C and 2A, 2B, 2C, as proposed, will not

cause Trusts 1A, 1B, 1C and 2A, 2B, 2C, or any secondary trust created under their terms, to lose its exempt status for generation-skipping transfer tax purposes of § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i). In addition, the reformation of Trusts 1A, 1B, 1C and 2A, 2B, 2C, as proposed, will not cause any distributions from those trusts, or any secondary trust created under their terms, to be subject to generation-skipping transfer taxes under § 2601. Accordingly, after the proposed reformation, Trusts 1A, 1B, 1C and 2A, 2B, 2C, and any secondary trust created under their terms, will continue to be exempt from the GST tax imposed under § 2601 provided there are no additions to those trusts after September 25, 1985.

ISSUE 2:

Section 2501 imposes a tax for each calendar year on the transfer of property by gift during such calendar year by any individual, resident or nonresident.

Section 2511 provides that, subject to certain limitations, the gift tax applies whether the transfer is in trust or otherwise, direct or indirect, and whether the property transferred is real or personal, tangible or intangible.

Section 2512(b) provides that, where property is transferred for less than adequate and full consideration in money or money's worth, the amount by which the value of the property transferred exceeds the value of the consideration received in exchange constitutes a gift subject to the gift tax.

In this case, as a result of the reformation of Trusts 1A, 1B, 1C and 2A, 2B, 2C, as proposed, each descendant of a primary beneficiary will relinquish contingent interests in the primary and secondary trusts established for the descendants of the other primary beneficiaries. However, the value of each beneficiary's contingent interest in the primary and secondary trusts established for his or her family line will be enhanced. Accordingly, we conclude that the proposed reformation of Trusts 1A, 1B, 1C and 2A, 2B, 2C and 2 or any secondary trust created under their terms, will not result in a transfer subject to gift tax under § 2501 by any of the beneficiaries.

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) 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 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.

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 Court 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.

Provided the State X court approves the petition for reformation, it is consistent with the Supreme Court's opinion in Cottage Savings to find that the interests of the beneficiaries of the reformed trusts will not differ materially from their interests in the original trusts. The proposed reformation accomplishes the same outcome as if the trusts had been partitioned along the family lines of the children of the Settlers. Except for the changes described above, all other provisions of Trust will remain unchanged. Accordingly, the proposed reformation will not result in a material difference in kind or extent of the legal entitlements enjoyed by the beneficiaries, and no gain or loss is recognized by the beneficiaries or the trusts on the partition for purposes of § 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. This ruling is directed only to the taxpayer(s) 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.

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

Sincerely,

George Masnik
Chief, Branch 4
(Office of Passthroughs and Special Industries)

Enclosure

Copy for section 6110 purposes

cc: