

Internal Revenue Service

Number: **200619001**

Release Date: 5/12/2006

Index Number: 2601.00-00, 61.00-00,
1001.00-00, 2036.00-00,
2037.00-00, 2038.00-00,
2041.00-00, 2501.01-00,
2514.00-00

Department of the Treasury

Washington, DC 20224

[Third Party Communication:

Date of Communication: Month DD, YYYY]

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B09

PLR-111429-05

Date:

January 23, 2006

In Re:

Legend:

Decedent	=
Trust	=
Court	=
Date 1	=

Dear :

This is in response to your letter dated February 24, 2005 and subsequent correspondence, requesting rulings on the income, estate, gift, and generation-skipping transfer (GST) tax consequences of certain proposed modifications to and construction of a trust.

Decedent died on Date 1, a date prior to September 25, 1985. The terms of her will established Trust for the benefit of her two sons and their children. Pursuant to Item IV of Trust, the trustees of Trust are Decedent's two sons.

Item IV further provides that Decedent's two sons are to "enjoy the rents, income and profits from my estate during their natural lives only; and that upon the death of each their respective children shall each have and enjoy their pro-rata shares of the rents, income and profits until they shall each attain the age of twenty-five years." When each grandchild turns age 25, he or she is to receive one-fourth of his or her share of the Trust corpus. When each grandchild turns age 30, he or she is to receive another one-fourth of his or her share of the Trust corpus. The remainder of his or her share of the Trust corpus is to be distributed to each grandchild when he or she turns age 35.

Item VI provides that in the event that either of Decedent's sons predeceases her or fails to serve as trustee, and the deceased son has a son who is at least 25 years old, then that son is to serve as co-trustee of Trust in place of his father.

Item VII provides, in part, that the trustees are directed to:

... use the proceeds, profits, returns or income from all the real or personal property in my estate as hereinabove provided for the benefit and enjoyment of my said two sons ... for and during the terms of the natural lives of each of them; and, at their respective deaths my said Trustees shall use the proceeds, profits, returns or income from all the real and personal property in my estate as hereinabove provided for maintenance, support and education of my said grandchildren during their minority and until date of distribution from said trust fund and property so held by my said Trustees in trust, whether it be or become necessary to encroach upon the corpus of said trust estate or principal thereof or not, to carry out my purpose and intent of creating this trust.

Since the Trust's inception, the sons, as trustees of Trust, have interpreted Items IV and VII to provide that during the lifetime of Decedent's sons, the sons are to receive all of the income of the Trust; and that upon the sons' deaths, their children will receive all of the income of the Trust and Trust corpus to provide for their maintenance, support, and education. It has been represented that there have been no additions to Trust since its inception.

The sons, as trustees of Trust, intend to petition Court for an interpretation of Trust's terms due to the difference in language between Item IV and Item VII. In addition, the sons intend to petition Court to modify Trust's terms to provide as follows. First, Trust will be divided into two separate trusts, one trust for the benefit of each son and that son's children. Each successor trust will be funded with pro rata shares of each asset of Trust so that each successor trust will hold exactly the same interest in Trust's assets as Trust held before the division.

Second, following the division of Trust into two successor trusts, the co-trustees of each successor trust will become the son for whom the successor trust was established and that son's oldest son. In the event the son's oldest son ceases to serve as co-trustee with his father for any reason, the successor trustee would be the next oldest son, or, if none, the next oldest child of the son for whom the successor trust was established.

Third, upon the death of the son for whom a successor trust was established, the successor trust is to be divided, per stirpes, into separate shares (second-tier successor trusts) for each living child of the son for whom the successor trust was established. These second-tier successor trusts will be funded with pro rata shares of each asset of the preceding trust so that each second-tier successor trust will hold exactly the same interests in the preceding trust's assets as the preceding trust held before the division.

The trustee of each of these second-tier successor trusts will be the child for whom the second-tier successor trust was established.

The following rulings have been requested.

1. The proposed division of Trust into two successor trusts and into second-tier successor trusts, and the proposed construction of Trust to clarify the terms of distribution will not be considered a sale, exchange, or other taxable distribution of Trust and will not cause either Trust, the successor trusts, the second-tier successor trusts, or the beneficiaries thereof to realize income, gain, or loss for the purposes of §§ 61 and 1001 of the Code.
2. The successor trusts and second-tier successor trusts to be created in connection with the proposed division and construction of Trust will remain exempt from the application of the federal GST by reason of the effective date rule contained in § 1433(b)(2) of Tax Reform Act of 1986 (Act), and the application of §§ 26.2601-1(b)(4)(i)(C) and 26.2601-1(b)(4)(i)(D) of the Generation-Skipping Transfer Tax Regulations.
3. The proposed division of Trust into successor trusts and into second-tier successor trusts and the proposed construction of Trust to clarify the terms of distribution will not cause any portion of either successor trust or any second-tier trust to be includible in the gross estate of any beneficiary of Trust, including one who is also a trustee of a successor trust or a second-tier successor trust, for federal estate tax purposes under §§ 2036, 2037, or 2038.
4. The proposed division of Trust into successor trusts and into second-tier successor trusts and the proposed construction of Trust to clarify the terms of distribution will not cause any beneficiary of Trust, including one who is also a trustee of a successor trust or a second-tier successor trust, to be treated as having a general power of appointment with respect to any portion of either the successor trusts or the second-tier successor trusts within the meaning of §§ 2041 or 2514.
5. The proposed division of Trust into successor trusts and into second-tier successor trusts and the proposed construction of Trust to clarify the terms of distribution will not create a transfer of property that is subject to federal gift tax under § 2501.

Law and Analysis:

Ruling No. 1

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.

Trust’s terms will be consistent with the successor trusts’ terms, and the second-tier successor trusts’ terms. Upon the proposed division of Trust into successor trusts and second-tier successor trusts, each beneficiary will have the same right to income and principal collectively under the successor trusts and the second-tier successor trusts as each beneficiary had under Trust. The proposed division will not result in any change in the beneficial interests of any beneficiary.

Therefore, based upon the facts submitted and the representations made, and provided the Court approves the proposed petition for construction and division as described herein, the construction of Trust to clarify the terms of distribution and the proposed division of Trust on a pro-rata basis into successor trusts and second-tier successor trusts does not create any material differences in the interests of the beneficiaries. The beneficiaries will hold essentially the same interests before and after the pro rata divisions. Accordingly, the proposed construction and division will not cause Trust, the successor trusts or the second-tier successor trusts or any of the beneficiaries to recognize any gain or loss from the sale or other disposition of property under §§ 61 or 1001.

Ruling Nos. 2-5:

Section 2033 provides that the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.

Section 2036(a) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death – (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Section 2037 provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time after September 7, 1916, made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, if – (1) possession or enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent, and (2) the decedent has retained a reversionary interest in the property (but in the case of a transfer made before October 8, 1949, only if such reversionary interest arose by the express terms of the instrument of transfer), and the value of such reversionary interest immediately before the death of the decedent exceeds 5 percent of the value of such property.

Section 2038(a)(1) provides that the value of the decedent's gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period on the date of the decedent's death.

Section 2041(a)(2) provides that the value of the decedent's gross estate shall include the value of all property over which the decedent has at the time of his death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under §§ 2035 to 2038, inclusive.

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 25.2511-2(b) of the Gift Tax Regulations provides that as to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete.

Section 2601 imposes a tax on every GST made after October 26, 1986. A GST is defined under § 2611(a) as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 2612(a) provides that the term taxable termination means a termination (by death, lapse of time, release of a power, or otherwise) of an interest in property held in trust where the property passes to a skip person with respect to the transferor of the property. Section 2612(b) provides that the term taxable distribution means any distribution from a trust to a skip person other than a taxable termination or a direct skip. Under § 2612(c)(1), a direct skip is a transfer subject to federal estate or gift tax made by a transferor to a skip person.

Under § 1433(a) of the Act, and § 26.2601-1(a), the GST is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i), the GST does not apply to a transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such 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)(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)(C) provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct scrivener's error will not cause an exempt trust to lose its exempt status provided the judicial action involves a bona fide issue, and the construction is consistent with applicable state law that would be applied by the highest court of the state.

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)(E), Example 3, provides as follows. In 1980, Grantor established an irrevocable trust for the benefit of Grantor's children, A and B, and their issue. The trust is to terminate on the death of the last to die of A and B, at which time the principal is to be distributed to their issue. However, the provision governing the termination of the trust is ambiguous regarding whether the trust principal is to be distributed per stirpes, only to the children of A and B, or per capita among the children, grandchildren, and more remote issue of A and B. In 2002, the trustee files a construction suit with the appropriate local court to resolve the ambiguity. The court issues an order construing the instrument to provide for per capita distributions to the children, grandchildren, and more remote issue of A and B living at the time the trust terminates. The court's construction resolves a bona fide issue regarding the proper interpretation of the instrument and is consistent with applicable state law, as it would be interpreted by the highest court of the state. Therefore, the trust will not be subject to the provisions of chapter 13.

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, Trust was irrevocable on September 25, 1985. It has been represented that no additions, actual or constructive, have been made to Trust after that date. The distribution provisions of Trust are ambiguous as to the distribution of Trust income and principal, and the proper distribution of Trust income and principal is a bona

fide issue. The sons, as trustees of Trust, intend to petition Court for an interpretation of Trust's distribution terms.

In addition, the sons, as trustees of Trust, intend to petition Court to divide Trust into successor trusts and second-tier successor trusts. This modification is similar to the modification described in § 26.2601-1(b)(4)(i)(E), Example 5. Consequently, the proposed division of Trust will not result in a shift of any beneficial interest in 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 Trust beyond the period provided for in Trust.

Accordingly, based upon the facts submitted and the representations made, and provided Court's interpretation of Trust's distribution provisions is consistent with applicable state law as it would be interpreted by the highest court of the state, we rule that Court's construction of Trust's distribution provisions and the division of Trust into successor trusts and second-tier successor trusts:

(1) will not cause Trust, the successor trusts, and the second-tier successor trusts to lose their status as exempt from the application of the federal GST by reason of the effective date rule contained in § 1433(b)(2) of the Act and § 26.2601-1(b)(1)(i), and the application of §§ 26.2601-1(b)(4)(i)(C) and 26.2601-1(b)(4)(i)(D);

(2) will not cause any portion of either successor trust or any second-tier trust to be includible in the gross estate of any beneficiary of Trust, including one who is also a trustee of a successor trust or a second-tier successor trust, for federal estate tax purposes under §§ 2036, 2037, or 2038;

(3) will not cause any beneficiary of Trust, including one who is also a trustee of a successor trust or a second-tier successor trust, to be treated as having a general power of appointment with respect to any portion of either the successor trusts or the second-tier successor trusts within the meaning of §§ 2041 or 2514; and

(4) will not create a transfer of property that is subject to federal gift tax under § 2501.

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

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

Enclosure: Copy for § 6110 purposes.

cc: