

Internal Revenue Service

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TY:

Legend

Grantor =
Spouse =
Grandchild 1 =
Grandchild 2 =
Grandchild 3 =
Date 1 =
First Trust =

Daughter =
First Trust 1 =
First Trust 2 =
First Trust 3 =
Second Trust =
Date 2 =
Date 3 =
Second Trust =
1
Second Trust =
2
Second Trust =
3
Date 4 =
Date 5 =
Date 6 =
State Statute =
Court =

Date 7 =

Dear

This is in response to your request for private letter ruling dated October 10, 2008, for each of First Trust 1, First Trust 2, First Trust 3, Second Trust 1, Second Trust 2, and Second Trust 3. In your capacity as trustee of each of these six trusts, you have asked for two rulings for each of these trusts. First, you have requested a ruling for each trust that the proposed trust consolidations of First Trust 2 and Second Trust 2 will not result in recognition of gain or loss under § 1001 of the Internal Revenue Code with respect to any trust assets. Second, you have requested a ruling that the proposed consolidations of the First Trusts and the Second Trusts will not result in any loss of current protection from the Generation-Skipping Transfer (“GST”) tax. This private letter ruling pertains specifically to Second Trust 2.

Facts

The facts submitted and representations made are as follows:

Grantor and Spouse created an irrevocable trust (First Trust) on Date 1, a date before September 26, 1985, for the benefit of their grandchildren. First Trust was immediately divided into two equal shares, one for the benefit of their son’s children and one for the benefit of Daughter’s children. This ruling concerns the trusts established for the benefit of Daughter’s children. Under the terms of First Trust, no distributions were to be made from the trust established for Daughter’s children until Daughter had children by birth or adoption. Subsequently, Daughter had 3 children, Grandchild 1, Grandchild 2, and Grandchild 3. On the birth of each grandchild, the trust established for Daughter’s children was subdivided into separate trusts, one trust for the benefit of each grandchild, as follows: First Trust 1 for the benefit of Grandchild 1; First Trust 2 for the benefit of Grandchild 2; and First Trust 3 for the benefit of Grandchild 3. There have been no additions to First Trust or First Trust 1, First Trust 2 or First Trust 3 since Date 1.

On Date 2, Grantor and Spouse created a joint revocable trust (Second Trust). Second Trust was amended and restated on Date 3. Grantor died on Date 4, a date after September 25, 1985. Under the terms of Second Trust, upon Grantor’s death, a portion of the Second Trust attributable to Grantor’s property, passed to a separate trust for the benefit of Daughter and her descendants. As a consequence of Daughter’s disclaimer this portion passed to 3 separate trusts: Second Trust 1 for the benefit of Grandchild 1; Second Trust 2 for the benefit of Grandchild 2; and Second Trust 3 for the benefit of Grandchild 3. It is represented that Daughter’s disclaimer constituted a qualified disclaimer, that satisfied the requirements of § 2518. Further, it is represented that a Form 706, United States Estate (and Generation-Skipping) Tax return was filed for Grantor’s estate and that on the return, a portion of Grantor’s GST exemption was

allocated with respect to the transfers to Second Trust 1, Second Trust 2 and Second Trust 3, in sufficient amount such that each trust then had an inclusion ratio of zero for purposes of § 2642.

Spouse died on Date 5. Under the terms of Second Trust, on Spouse's death, a portion of the remaining Second Trust corpus attributable to Spouse's property passed to a separate trust for the benefit of Daughter and her descendants. As a consequence of Daughter's disclaimer, this portion passed in equal shares to Second Trust 1, Second Trust 2, and Second Trust 3. It is represented that Daughter's disclaimer constituted a qualified disclaimer that satisfied the requirements of § 2518. Further, it is represented that a Form 706, United States Estate (and Generation-Skipping) Tax return was filed for Spouse's estate and that on the return, a portion of Spouse's GST exemption was allocated with respect to the additional transfers to Second Trust 1, Second Trust 2 and Second Trust 3, in sufficient amount such that the inclusion ratio with respect to each trust continued to be zero for purposes of § 2642. See § 26.2642-4(a).

Under the terms of First Trust 1, First Trust 2 and First Trust 3, the child of Daughter who is the primary beneficiary of the trust is entitled to distributions of principle and income in the trustee's discretion to provide for the beneficiary's health, maintenance, support and education. The primary beneficiary is also entitled to 1/4 of the remaining trust principle at age 35, 1/3 of the then remaining principal at age 40, 1/2 of the then remaining principal at age 45, and the balance of the trust estate at age 50. If the primary beneficiary fails to survive to age 50, the balance of the trust passes, per stirpes, to the primary beneficiary's then living descendants; or if there are no living descendants, then to the primary beneficiary's then living siblings or per stirpes to the descendants of a predeceased sibling; or if there are no such persons then living then to the living grandchildren of Daughter's parents (Grantor and Spouse).

Under the terms of First Trust 1, First Trust 2 and First Trust 3, unless a trust is sooner terminated under the terms of the trust, each trust must terminate no later than 21 years after the death of the last survivor of Grantor and Spouse's descendants who were living on Date 1. Further, subject to this provision, all interests in the three trusts will necessarily vest no later than Date 6, when the youngest primary beneficiary attains the age of 50.

Under the terms of Second Trust 1, Second Trust 2 and Second Trust 3, the child of Daughter who is the primary beneficiary of the trust is entitled to receive all trust income at least quarterly. In addition, to the extent income is insufficient, the trustee has the discretion to distribute sufficient principle to provide for the beneficiary's health, maintenance, support and education. The primary beneficiary is also entitled to 1/4 of the remaining trust principle at age 35, 1/3 of the then remaining principal at age 40, 1/2 of the then remaining principal at age 45, and the balance of the trust estate at age 50.

If the primary beneficiary fails to survive to age 50, then (subject to the limitations described below) the balance of the trust passes, per stirpes, to the primary beneficiary's then living descendants; or if there are no living descendants, then to the primary beneficiary's then living siblings or per stirpes to the descendants of a predeceased sibling; or if there are no such persons then living then to the descendants of Grantor and Spouse by right of representation. However, the trust contains several additional provisions impacting on this distribution scheme. Under the terms of the trusts, if any property passes to anyone under the age of 50 (other than a grandchild who is a primary beneficiary) a new trust is established for that person that will continue until that person attains age 50. Further, property passing to a person who already has a trust operating under the document, will be added to that trust.

In the event that all descendants of Grantor and Spouse die prior to having attained age 50 and within the applicable perpetuities period, then specified amounts are to be distributed to named individuals or their issue, with the balance distributed to certain educational institutions. Finally, unless a trust is sooner terminated under the provisions of the trust, each of Second Trust 1, Second Trust 2 and Second Trust 3, must terminate no later than 21 years after the death of the last survivor of those of Grantor and Spouse's descendants who were living on the date of death of the first spouse to die (that is, the date of Grantor's death.)

On Date 7, Court, pursuant to Daughter's petition, issued an order contingent on receipt of a favorable private letter ruling from the IRS, consolidating the trusts. Under the order, First Trust 1 is to be consolidated with Second Trust 1; First Trust 2 is to be consolidated with Second Trust 2; and First Trust 3 is to be consolidated with Second Trust 3. The Court decree provides in relevant part that the contemplated consolidation shall not alter or amend the beneficial interests of any present or future beneficiaries of the trust, vested or contingent. Because there are differences in the distribution provisions of First Trust 1, First Trust 2 and First Trust 3, as compared to Second Trust 1, Second Trust 2 and Second Trust 3, each consolidated trust will have two trust shares, a First Trust share and a Second Trust share. The First Trust share will remain subject to the distribution provisions of First Trust, and the Second Trust share will remain subject to the distribution provisions of Second Trust. Under the order, a "distribution provision" is defined as any provision that could impact the rights and remedies of any beneficiaries including distribution rights, rights to accounts, and rights to seek redress for breach of trust. Further, the term includes the perpetuity savings clauses contained in each respective trust. The Second Trust provisions governing the appointment of trustees will apply to each consolidated trust. The Court order also provides a comprehensive statement and accompanying exhibit describing the methodology to be used to determine each share on a continuing basis and the methodology to be used in accounting for trust distributions and expenses.

State Statute provides that if the terms of two or more trusts are substantially similar, on petition by a trustee or beneficiary, the court, for good cause shown, may combine the

trusts if the court determines that administration as a single trust will not defeat or substantially impair the accomplishment of the trust purposes of the interests of the beneficiaries.

Law and Analysis

Issue 1: You have requested a ruling for each trust that the proposed trust consolidations of First Trust 2 and Second Trust 2 will not result in recognition of gain or loss under § 1001 of the Internal Revenue Code (Code) with respect to any trust assets.

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(b) defines the amount realized from the sale or disposition of property as the sum of any money received plus the fair market value of any property received.

Section 1001(c) provides that, 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, 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 either in kind or in extent, is treated as income or 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). §1.1001-1.

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

In Silverstein v. United States, 419 F.2d 999 (7th Cir. 1969), aff'g 293 F. Supp. 1106 (N.D. Ill. 1968), cert. denied, 397 U.S. 1041 (1970), the court held that a nonrealization event occurs when, despite the form of the transaction, in substance the taxpayer holds the same property interest after a transaction as before, is as secure with respect to the interest after the transaction as before, and there is no realistic difference in the value of the property interest held as a result of the transaction.

Based on the information submitted and the representations made, the beneficiaries of Second Trust 2 will possess the same interests before and after the consolidation of First Trust 2 and Second Trust 2 and the proposed consolidation will merely be a merging of the assets for administrative convenience. Accordingly, we conclude that with respect to Second Trust 2 no sale or exchange under §1001 will occur as a result of the proposed merger and consolidation of First Trust 2 and Second Trust 2. In addition, no gain or loss will be realized by First Trust 2 or Second Trust 2 on any trust assets or by any beneficiaries as a result of the proposed merger and consolidation.

Issue 2: You have also requested a ruling that the proposed consolidation of trusts will not result in any loss of current protection from the GST tax.

Section 2601 imposes a tax on each generation skipping transfer. Section 2602 provides that the amount of the GST tax is determined by multiplying the taxable amount by the applicable rate. Section 2641(a) provides that the term "applicable rate" means with respect to any GST transfer, the product of the maximum federal estate tax rate and the inclusion ratio with respect to the transfer.

Under § 2642(a)(1), the inclusion ratio with any property transferred in a generation-skipping transfer is generally defined as the excess of 1 over the "applicable fraction". The applicable fraction, as defined in § 2642(a)(2) is a fraction, the numerator of which is the amount of GST exemption under § 2631 allocated to the trust (or to property transferred in a direct skip), and the denominator is the value of the property transferred to the trust or involved in the direct skip.

Section 2631(a) provides generally that, for purposes of determining the inclusion ratio, every individual shall be allowed a GST exemption amount which may be allocated by such individual (or his executor) to any property with respect to which such individual is the transferor.

Under § 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 under §§26.2601-1(b)(1), (2) or (3) 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 §§ 2601-1(b)(4)(i)(A), (B), or (C) by judicial reformation, or no judicial 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. Furthermore, 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 a shift in a beneficial interest in a trust.

Section 26.2601-1(b)(4)(i)(E), Example 6, considers a situation where the grantor, in 1980, establishes 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 example concludes that the trust that resulted from the merger will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

In the present case, First Trust 1, First Trust 2, and First Trust 3 were irrevocable prior to September 25, 1985, and, as such, are not subject to the GST tax by reason of § 26.2601-1(b)(1)(i). Second Trust 1, Second Trust 2 and Second Trust 3 are exempt from the GST tax because it is represented that the executor of Grantor's estate and the executor of Spouse's estate allocated a sufficient amount of GST exemption to Grantor's and Spouse's respective transfers to these trusts such that these trusts have an inclusion ratio of zero.

As noted above, the rules in § 26.2601-1(b)(4)(i) apply in the case of trusts that are exempt from GST tax because the trusts were in existence and irrevocable prior to

September 25, 1985. No guidance has been issued concerning modifications that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption was allocated to the trusts to result in an inclusion ratio of zero. At a minimum, a modification that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of such a trust.

Based on the facts presented and representations made, we conclude that the judicial consolidation of First Trust 1 and Second Trust 1, First Trust 2 and Second Trust 2, and First Trust 3 and Second Trust 3, as described above, will not shift any beneficial interest in the trusts 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. In addition, the consolidation of trusts will not extend the time for vesting of any beneficial interest in the trusts beyond the period provided for in First Trust and Second Trust. Further, the modification subjecting the consolidated trusts to the Second Trust provisions governing the appointment of trustees is administrative in nature.

Conclusions

1. Based on the information submitted and the representations made, we conclude that no sale or exchange under §1001 will occur as a result of the proposed merger and consolidation with respect to Second Trust 2. In addition, no gain or loss will be realized by First Trust 2 or Second Trust 2 on any trust assets or by any beneficiaries as a result of the proposed merger and consolidation.

2. Based on the facts submitted and the representations made, we also conclude that the Court Order providing for the consolidation of First Trust 1 and Second Trust 1, First Trust 2 and Second Trust 2, and First Trust 3 and Second Trust 3 will not cause the First Trust Share of each consolidated trust to be subject to the generation-skipping transfer tax imposed by chapter 13 of the Internal Revenue Code. Further, the consolidation pursuant to the Court Order will not cause the Second Trust Share of each consolidated trust to have an inclusion ratio in excess of zero.

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) of the Code 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.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

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,

George F. Wright
Senior Technician Reviewer, Branch 5
Office of Chief Counsel
(Income Tax & Accounting)

Enclosure (1)

cc: