Internal Revenue Service

Number: **200441013**
Release Date: 10/8/04
Index Number: 1361.03-02

Department of the Treasury
Washington, DC 20224

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Refer Reply To:
CC:PSI:B1 – PLR-118341-03
Date:
March 02, 2004

Legend

H =

W =

X =

Y =

GRAT A =

GRAT B =

Exempt QSST A =

Non Exempt QSST A =

Exempt QSST B =

Non Exempt QSST B =

D1 =

D2 =

D3 =

D4 =

D5 =

N1 =

N2 =

N3 =

N4 =

State =

Dear :

This responds to your letter dated, March 17, 2003, on behalf of the taxpayer, Exempt QSST A, requesting rulings under §§ 61, 1001, 1361(d)(3), and 2601 of the Internal Revenue Code.

FACTS

X is a corporation organized under the laws of State. It filed an election to be treated as an S corporation under § 1362(a), effective D1.

H and W, as grantors, formed GRAT A and GRAT B under the laws of State, on D2, for the benefit of Y. On D2, GRAT A and GRAT B each acquired N1 shares of X nonvoting common stock and N2 shares of X voting common stock.

The instruments creating the GRATS provide, in part, that:

Article 2.1

From the date of this agreement until the fifth anniversary of the date of this Agreement or the Grantor's earlier death ("the Trust term"), the Trustee shall pay to the Grantor (the "Annuitant") an "Annuity Amount" * * * .

Article 2.2

The Trust Term expires on the fifth anniversary of the date of this Agreement and Grantor's daughter Y, or any of her descendants is living, the Trustee shall divide the trust assets as provided in Article 2.3 * * *.

Article 2.3

If the Trust Term expires on the fifth anniversary of the date of this Agreement and Y or any of Y's descendants is then living, the Trustee shall divide the trust assets as follows:

(a) The Trustee shall first set apart property in an amount equal in value to the Grantor's unused generation-skipping tax exemption (as defined in Article 5.11.3).This amount shall be distributed to and held by the Trustee of the EXEMPT TRUSTS under Article 3.

(b) The balance of the trust assets shall be distributed to and held by the Trustee of the NONEXEMPT TRUSTS under Article 4 for the benefit of Y (if and while Y is living) and her decedents.

Article 3.2

If Y is living at the time the trust estate is received by the Trustee, the Trustee shall hold the property of the trust estate as a separate Exempt Trust for the benefit of Y under the provisions of this Article.

Article 3.2.1

During Y's lifetime, the Trustee may distribute to, or for the benefit of Y, so much of the net income and principal of the trust, up to the whole thereof, as the Trustee determines is required to provide for the beneficiary's health, support, maintenance and education.

Article 3.2.2

Any income of the trust not distributed in a calendar year shall be accumulated and added to principal at or prior to the end of such year.

Article 3.2.4

If any time during Y's lifetime the Trustee (other than Y) determines that prevailing circumstances no longer justify the continuation of the trust, that Trustee may terminate the trust and distribute all the remaining trust property to Y.

Article 3.2.5

Unless the trust has been terminated earlier under the provisions of Article 3.2.4, the trust shall terminate upon Y's death. Upon termination the Trustee shall distribute the property of the trust as Y, by will, appoints outright or in trust to and among H's and W's descendents, or if none are living, to any one or more of the spouses of H's and W's descendants and any one or more organization to which a gift may qualify as a "charitable contribution" under § 170(c) and qualifies for a "charitable deduction" under §§ 2055(a) and 2522(a). The power of appointment may not be exercised to postpone the vesting of any interest in the trust for a period longer than 21 years after the death of the last to die of all of the beneficiaries of the trusts created under this Agreement who were living or conceived on the date of this Agreement.

Article 5.6

The Trustee of two or more trusts created by this or any other instrument may merge such trusts if the beneficiary or beneficiaries are the same and the terms of the trusts are substantially the same.

Article 5.10.1

The beneficiary (or the beneficiary's legal representative) may elect to have § 1361(d)(2) of the Code apply to one or more of such corporations. If such an election is made, all provisions of the trust shall be interpreted, construed and administered in a manner consistent with the Grantor's intention that the trust be treated for all purposes as a qualified Subchapter S trust.

Article 5.10.2

Notwithstanding any provision of this Agreement directing otherwise, if rules applicable to a qualified Subchapter S trust at the time when Subchapter S stock is distributable to the trust in monthly or quarterly installments to, or for the benefit of, the beneficiary, and no distributions of income or principal from the trust go to any other person except the beneficiary during the beneficiary's lifetime.

On D3, GRAT A's term expired, resulting in Exempt QSST A and Non Exempt QSST A being formed on D4. GRAT A transferred N3 shares of X nonvoting common stock to Exempt QSST A, equaling the grantor's unused GST tax exemption. GRAT A transferred N2 shares of X voting common stock, and N4 shares of X nonvoting common stock to Non Exempt QSST A. Exempt QSST A and Non Exempt QSST A each filed a qualified subchapter S trust ("QSST") election under § 1361(d)(2), effective D4. On or about D5, H and W allocated their remaining GST exemption amounts to Exempt QSST A on a Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return.

On D3, GRAT B's term also expired, resulting in Exempt QSST B and Non Exempt QSST B being formed on D4. GRAT B also transferred N3 shares of X nonvoting common stock to Exempt QSST B, equaling the grantor's unused GST tax exemption. GRAT B transferred N2 shares of X voting common stock, and N4 shares of X nonvoting common stock to Non Exempt QSST B. Exempt QSST B and Non Exempt QSST B each filed a QSST election, effective D4. On or about D5, H and W allocated their remaining GST exemption amounts to Exempt QSST B on a Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return.

Exempt QSST B proposes to merge with and into Exempt QSST A pursuant to article 5.6 of the GRAT agreements. In addition to the facts discussed above, the taxpayer represents the following:

- No additions have been made to Exempt QSST A or to Exempt QSST B since initial funding.
- The terms and provisions of Exempt QSST A and Exempt QSST B are substantially identical;
- Y is the beneficiary of both Exempt QSST A and Exempt QSST B;
- Exempt QSST A and Exempt QSST B have continuously qualified as QSSTs since the D3 effective date of their QSST elections;
- X has consistently treated Y as the owner of the X stock held by Exempt QSST A and Exempt QSST B, and all of Y's tax returns have been filed consistent with that status;
- The merger will not change the quality or value of Y's interest in either Exempt QSST A's or Exempt QSST B's assets, and that it will not confer upon Y any additional powers or beneficial interests;
- The merger is being proposed to simplify the management and administration of the trusts.

Following the merger, the terms of Exempt QSST A will continue to provide that (1) during the life of the current income beneficiary there shall be only one income beneficiary of trust; (2) any corpus distributed during the life of the current income beneficiary may be distributed only to the income beneficiary; (3) the income interest of the current income beneficiary in the trust shall terminate on the earlier of the beneficiary's death or termination of the trust; and (4) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to that beneficiary, and (5) all of the income will be distributed (or required to be distributed) currently to one individual who is a citizen or resident of the United States.

LAW AND ANALYSIS

Sections 61 and 1001 Ruling

Section 61 of the Code provides that gross income means all income from whatever source derived.

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 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 such section 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 received. Section 1001(c) provides that, except as otherwise provided in subtitle A, the entire amount of the 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 as loss sustained.

In Cottage Savings Assoc. v. Commissioner, 499 U.S. 554 (1991), the Supreme Court addressed whether a sale or exchange has taken place that results in a realization of gain or loss under § 1001 of the Code. The Court stated that an exchange of property gives rise to a realization event under § 1001(a) if the properties exchanged are materially different. Consequently, the Court held that an exchange of mortgages constituted a realization event under § 1001(a) because the exchanged interests - loans that were made to different obligors and secured by different homes - were legally distinct entitlements.

Section 1361(d)(3) Ruling

Section 1361(a)(1) defines an S corporation as a small business corporation for which an election under § 1362(a) is in effect. Section 1361(b)(1) defines "small business corporation" as a domestic corporation that is not an ineligible corporation and that does not (A) have more than 75 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in (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)(i) provides that a trust, all of which is treated (under subpart E of part I of subchapter J of chapter 1) as owned by an individual who is a citizen or resident of the United States, may be a subchapter S corporation shareholder.

Section 1361(d)(1) provides that a QSST, with respect to which a beneficiary makes an election under § 1361(d)(2), will be treated as a trust described in § 1361(c)(2)(A)(i), and the QSST's beneficiary will be treated as the owner (for purposes of § 678(a)), of that portion of the QSST's S corporation stock to which the election under § 1361(d)(2) applies.

Under § 1361(d)(2)(A), the beneficiary of a QSST may elect to have § 1361(d) apply. Under § 1361(d)(2)(D), this election will be effective up to 15 days and two months before the date of the election.

Section 1361(d)(3)(A) provides that a QSST is a trust, the terms of which require that (i) during the life of the current income beneficiary there shall be only 1 income beneficiary of the trust, (ii) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary, (iii) the income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary's death or the termination of the trust, and (iv) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary. In addition, § 1361(d)(3)(B) requires that the trust distribute all of its income (within the meaning of § 643(b)) currently to one individual who is a citizen or resident of the United States.

Section 1.1361-1(j)(7) provides that the beneficiary of the QSST who is treated as the owner of that portion of the trust that consists of S corporation stock is treated as the shareholder for the purpose of § 1361(b)(1) (defining the term "small business corporation").

Section 2601 Ruling

Section 2601 of the Internal Revenue Code imposes a tax on each generation-skipping transfer (GST) which includes under § 2611(a) a taxable distribution, a taxable termination, and a direct skip.

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.

Section 2602 provides that the amount of the tax imposed by § 2601 is (1) the taxable amount (determined under subchapter C), multiplied by (2) the applicable rate (determined under subchapter E).

Section 2641 provides that the term "applicable rate" means, with respect to any GST, the product of (1) the maximum Federal estate tax rate, and (2) the inclusion ratio with respect to the transfer.

Section 2631(a) provides that for purposes of determining the inclusion ratio, every individual is allowed a GST exemption of $1,000,000 (adjusted for inflation) that may be allocated by such individual (or his executor) to any property with respect to which such individual is the transferor.

Section 2642(a) provides that the inclusion ratio is the excess, if any, of 1 over the applicable fraction determined for the trust from which the transfer is made, or in the case of a direct skip, the applicable fraction determined for the skip. The applicable fraction is a fraction in which the numerator is the amount of the GST exemption allocated to the trust, or in the case of a direct skip, allocated to the property transferred in the skip, and the denominator is the value of the property transferred to the trust or transferred in the direct skip, reduced by any Federal estate tax or State death tax actually recovered from the trust attributable to the property and any charitable deduction allowed under §§ 2055 and 2522 with respect to the property.

Section 26.2654-1(a)(2)(i) of the Generation-Skipping Transfer Tax Regulations provides that, if there is more than one transferor with respect to a trust, the portions of the trust attributable to the different transferors are treated as separate trusts for purposes of chapter 13.

CONCLUSION

Sections 61 and 1001 Ruling

In the present case, the terms and conditions of each of the merged trusts are substantially identical to the terms and conditions of the surviving trust. Because the property interests and legal entitlements of the beneficiaries will remain unchanged by the proposed mergers, it is consistent with Cottage Savings to find that the beneficiaries' interests after the proposed mergers will not differ materially from the beneficiaries' interests before the proposed merger. Thus, the proposed mergers will

not result in the realization of any gain or loss or other taxable event under §§ 61 or 1001 of the Code to the current trust beneficiary.

Section 1361(d)(3) Ruling

Article 5.6 of the instrument creating Exempt QSST A and Exempt QSST B allows for a merger of similar trusts only when the trusts have the same income beneficiary. Under §1.1361-1(j)(7), the X shares which make up the corpus of Exempt QSST A and Exempt QSST B are treated as directly owned by Y. Any transfer of the X shares, pursuant to a merger under Article 5.6, would effectively be a transfer of the shares from Y to Y. Therefore, inclusion of Article 5.6 permitting the merger of similar trusts did not make either trust ineligible to be a QSST. Provided that both Exempt QSST A and Exempt QSST B qualified as QSSTs on the date that Exempt QSST B transferred its X shares to Exempt QSST A, the transfer did not terminate Exempt QSST A's QSST election.

Section 2601 Ruling

In the present case, the terms of Exempt QSST A and Exempt QSST B are identical, and each trust has an inclusion ratio of zero. H is the transferor for GST purposes with respect to Exempt QSST A and W is the transferor with respect to Exempt QSST B. After the merger, the portion of the successor trust (Exempt QSST A) attributable to W and the portion of the successor trust attributable to H will be treated as separate trusts for purposes of chapter 13 and each portion will have a zero inclusion ratio for purposes of § 2601.

Therefore, based on the facts submitted and representations made, we conclude:

(a) After the merger, the inclusion ratio with respect to Exempt QSST A will continue to be zero.

(b) The act of merging the trusts will not cause any distributions from Exempt QSST A to become subject to GST tax (provided there are no post-merger additions to Exempt QSST A).

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed on whether X is a subchapter S corporation for federal tax purposes, or whether any of the trusts discussed qualify as QSSTs.

This ruling is directly only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that if may not be used or cited as precedent.

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely,

/s/ Dan Carmody

Dan Carmody
Senior Counsel, Branch 1
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes

cc: