

Internal Revenue Service

Department of the Treasury
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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

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Date: APRIL 21, 2004

In Re:

Legend:

Decedent =

State X =

Year 1 =

Spouse =

Child 1 =

Child 2 =

Child 3 =

Grandchild 1 =

Grandchild 2 =

Grandchild 3 =

Grandchild 4 =

Greatgrandchild 1 =

Greatgrandchild 2 =

Greatgrandchild 3 =

Trust =

Charity 1 =

Charity 2 =

Year 2 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Greatgrandchild 4 =
Greatgrandchild 5 =
Greatgrandchild 6 =
Greatgrandchild 7 =
Greatgrandchild 8 =
Greatgrandchild 9 =
Greatgrandchild 10 =
Greatgrandchild 11 =
Y =
Trust 1 =

Trust 2 =

Dear _____ :

This is in response to a letter dated January 26, 2004, and other correspondence, requesting rulings regarding the income, gift and generation-skipping transfer (GST) tax consequences of a proposed judicial construction of Trust to permit proposed sales of remainder interests in Trust.

Facts

The facts submitted and representations made are as follows. The Decedent, a resident of State X, died testate in Year 1. At the time of his death, the Decedent was survived by his Spouse, Child 1, Child 2, Child 3, and the following lineal descendants of Child 3: Grandchild 1, Grandchild 2, Grandchild 3, Grandchild 4, Greatgrandchild 1, Greatgrandchild 2, and Greatgrandchild 3. At the time of the Decedent's death, Greatgrandchild 3 was in utero. After the Decedent's death, eight additional greatgrandchildren, Greatgrandchild 4 through Greatgrandchild 11, were born and are currently living. All are lineal descendants of Child 3.

Article Sixth of the Decedent's will created Trust, a residuary trust with respect to which the Spouse was the trustee. Under the terms of the Trust, Child 1 was entitled to receive distributions from income not exceeding \$250 per month for reasonable care, comfort and support. All net income, after the distributions to Child 1, was paid to Spouse for her life. After Spouse's death, all the income, after the distributions to Child 1, is to be distributed equally to Child 2 and Child 3. Upon the death of Child 2 or Child 3, each child's share of the income will be paid to that respective child's issue. If either Child 2 or Child 3 has no surviving issue, that child's share will augment the share to the surviving child or his or her issue. In addition, the trustee may make discretionary distributions of principal for an income beneficiary's "reasonable maintenance, comfort and support for expenses of accident, illness or other misfortunes." The Trust will terminate upon the death of the last to die of the Spouse, Child 1, Child 2, and Child 3,

and the "issue" of Child 2 and Child 3. At that time, the corpus and any undistributed income will be paid one-half to Charity 1 and one-half to Charity 2.

The will also contains a spendthrift clause which provides that:

each beneficiary hereunder is hereby restrained from anticipating, encumbering, alienating, or in any other manner assigning his or her interest or estate in either principal or income, and is without power to do so, nor shall such interest or estate be subject to his or her liabilities or obligations, nor to judgment or other legal process, bankruptcy proceedings or claims of creditors or others. All income and principal, or either of them, shall be payable and deliverable only and personally to the respective beneficiaries entitled thereto.

In Year 2, the Decedent's estate sought and received an order from the appropriate local State X court for an accounting and distribution of the estate. Included in the order was a statement that the Trust would terminate (and distribution to the charities would occur) on the death of the last survivor of the beneficiaries, namely, Spouse, Child 1, Child 2, Child 3, "and the last survivor of the issue of said [Child 3] living at the death of said [Decedent]," specifically referencing Grandchild 1, Grandchild 2, Grandchild 3, and Grandchild 4. Thus, for the purpose of determining the measuring lives for the duration of the Trust, the order purported to specifically name the individuals that comprised the class defined as "issue" under the Trust and limited this class to certain specified children of Child 3 living at Decedent's death. Grandchildren of Child 3 living at Decedent's death were not listed as measuring lives. The order also required that the distributions to the charities were to be used only for their charitable purposes.

You represent that Spouse, Child 1 and Child 2 are deceased and that Child 2 had no issue. Child 3 is living and, as noted above, has issue living. Consequently, Child 3 is currently the only income beneficiary. The living descendants of Child 3 include Grandchildren 1 through 4 and Greatgrandchildren 1 through 3, all of whom were living at the time of the decedent's death, and eight additional greatgrandchildren, Greatgrandchild 4 through Greatgrandchild 11, who were born after the Decedent died.

Some of the descendants of Child 3 petitioned the appropriate court for an order that the omission of Greatgrandchildren 1 through 3 (who were living at the Decedent's death) from the list of measuring lives for determining when Trust will terminate in the Year 2 court order was a clerical error. Charity 1 and the grandchildren of Child 3 entered into a settlement. Under the settlement, on Date 1, Charity 1 sold its interest to existing trusts previously established for the benefit of the 11 then-living grandchildren of Child 3 (i.e., greatgrandchildren of the Decedent, all of whom are issue of Child 3) and/or directly to the current beneficiaries of such trusts. The value of Charity 1's interest was determined by computing an amount half way between the present value, computed pursuant to § 7520, of the interest assuming Greatgrandchildren 1 through 3

were not measuring lives and the present value of the interest assuming that the Greatgrandchildren 1 through 3 were measuring lives. On Date 2, the court approved this settlement in an order that bound all of the parties, including Charities 1 and 2.

The trusts entering into the transaction were established for the benefit of specific grandchildren of Child 3. The terms of each trust, other than different beneficiaries, are virtually identical. Each trust is irrevocable and provides for the net income to be paid at least annually to the beneficiary for the term of the trust and gives the trustee the discretion to distribute principal to the beneficiary for the beneficiary's proper care, medical treatment, welfare, maintenance, and education. No income or principal may be distributed to anyone other than the beneficiary during the term of the trust. Each trust will terminate at the earlier of 20 years from the date it was created or the death of the beneficiary. At termination, the trust corpus will be distributed to the beneficiary, if living, or as directed by the beneficiary pursuant to the exercise of a testamentary general power of appointment or, if not exercised, to the beneficiary's estate.

The Service issued a ruling on Date 3 as supplemented on Date 4, that the settlement would not affect the exempt status of Trust for generation-skipping transfer tax purposes. In the ruling request, it was represented that, if no court decision was entered on the merits of the controversy as to the date of trust termination, the portion of the trust representing Charity 1's interest would terminate on the date that references Spouse, Child 1, Child 2, Child 3, Grandchild 1, Grandchild 2, Grandchild 3, Grandchild 4, and Greatgrandchild 1, Greatgrandchild 2, and Greatgrandchild 3 as the measuring lives.

On Date 5, the court issued an order (that bound all of the parties, including Charities 1 and 2) correcting the Year 2 court order nunc pro tunc and interpreting that order to include Greatgrandchildren 1 through 3 in the list of measuring lives. Thus, under the Date 2 court order, Trust will terminate on the death of the last to die of Child 3, Grandchild 1, Grandchild 2, Grandchild 3, Grandchild 4 and Greatgrandchild 1, Greatgrandchild 2, and Greatgrandchild 3.

As a result of the sale by Charity 1 of its remainder interest to Decedent's 11 then-living greatchildren, Greatgrandchild 1, Greatgrandchild 2, Greatgrandchild 3, Greatgrandchild 4, and Greatgrandchild 8 each own a 5 percent remainder interest in Trust; Greatgrandchildren 5 through 7 each own a $8 \frac{1}{3}$ percent remainder interest; Greatgrandchild 9 owns a 25 percent remainder interest; and Greatgrandchildren 10 and 11 each own a $12 \frac{1}{2}$ percent remainder interest.

Greatgrandchildren 2 and 9 each propose to sell a 5 percent remainder interest in Trust in equal shares to Greatgrandchild 3, Greatgrandchild 4, and Greatgrandchild 8. The proposed sale would reduce the remainder interest owned by Greatgrandchild 9 from 25 to 20 percent and the remainder interest owned by Greatgrandchild 2 from 5 percent to zero.

In addition, Grandchild 4 created a substantially identical irrevocable trust for each of his sons, Greatgrandchildren 10 and 11, and the descendants of each son (Trust 1 and Trust 2, respectively). Greatgrandchildren 10 and 11 will each sell all or part of his 12 percent remainder interest in Trust to Trust 1 and Trust 2, respectively.

On the date of the proposed sale of the remainder interests in Trust, all of the assets of Trust will be marketable securities, except one parcel of real estate, with a current fair market value estimated at \$y.

In all of the proposed sales of remainder interests in Trust, the sales price of the remainder interests will equal (1) the fair market value of the assets of Trust on the date of sale, (2) multiplied by the § 7520 actuarial remainder factor then in effect, and (3) then multiplied by the fraction representing that portion of the remainder interest subject to the sale.

Under the terms of Trusts 1 and 2, each great grandchild is the primary beneficiary of his trust during his life. Each trust will pay any part of the income and principal of a primary beneficiary's share to any among the primary beneficiary and the primary beneficiary's descendants from time to time living and at such times as the trustee deems advisable for the health, support, maintenance in reasonable comfort, education and best interests of the beneficiaries. A primary beneficiary is granted a testamentary special power to appoint in trust that beneficiary's share to any persons in a specified class. Any part of that share the primary beneficiary fails to appoint will be divided into separate shares, and held under the terms of the trust, as specified among a group including the then living lineal descendants of Grandchild 4, a named niece and nephew of Grandchild 4's spouse or their then living lineal descendants, and the then living grandchildren of Child 3, excluding Greatgrandchild 2. If at any time there is no then living descendant of Grandchild 4's parents or of the parents of Grandchild 4's spouse, the remaining trust assets will be distributed to charity. Each trust is intended to be a Qualified Perpetual Trust under applicable state law, to which the rule against perpetuities does not apply.

It is represented that no additions, constructive or otherwise, have been made to Trust subsequent to September 25, 1985, and that, other than the Date 5 court order, Trust has not been amended or otherwise altered in any manner since September 25, 1985.

The trustee of Trust has petitioned the appropriate court for an order that construes the spendthrift provision of Trust to permit the proposed sales. The court will issue the following order:

The Spendthrift Clause provision of [Trust] restraining transfer of a beneficiary's interest does not prohibit the Proposed Sales, as defined herein, of the Purchased Remainder Interests, as defined herein, because the Spendthrift Clause does not apply to the interests acquired after

[Decedent's] death under the [settlement approved by the appropriate court on Date 2], but only to beneficial interests arising under the terms of [Decedent's] Will itself.

The trustee has requested the following rulings:

1. The court construction of the spendthrift clause and provisions of Trust to allow the proposed sales of remainder interests in Trust will not affect the exempt status of Trust for GST tax purposes.
2. The proposed sales of remainder interests in Trust will not affect the exempt status of Trust for GST tax purposes.
3. The proposed sales of remainder interests in Trust will not result in any taxable gifts for federal gift tax purposes as to the buyers or sellers of such interests.
4. The court approval of the proposed sales of remainder interests in Trust despite the spendthrift clause will not result in the recognition of gain or loss to the trust or any trust beneficiaries.
5. A gain or loss for each of the proposed sales will occur equal to the difference between the amount realized for the remainder interest and the cost that the seller incurred to acquire the remainder interest.

Law and Analysis

Rulings 1 & 2:

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

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

Under § 2652(a)(1), for purposes of chapter 13, the term "transferor" means the decedent, in the case of any property subject to tax imposed by chapter 11 and, donor, in the case of any property subject to tax imposed by chapter 12. The individual with respect to whom property was most recently subject to federal estate or gift tax is the transferor of that property for purposes of chapter 13. Section 26.2652-1(a)(1) of the Generation-Skipping Transfer Tax Regulations. Thus, an individual may be a transferor even though there is no transfer of property under local law at the time the federal

estate or gift tax applies. Section 26.2652-1(a)(2) states that for purposes of chapter 13, a transfer is subject to federal gift tax if a gift tax is imposed under § 2501(a) (without regard to exemptions, exclusions, deductions, and credits).

Under § 1433(a) of the Tax Reform Act of 1986 (Act), the generation-skipping transfer tax is generally applicable to generation-skipping transfers made after October 22, 1986. Under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i), the tax does not apply to any generation-skipping transfer from a trust, if the trust was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date. Under § 26.2601-1(b)(1)(ii), any trust in existence on September 25, 1985, will be considered irrevocable unless the settlor had a power that would have caused inclusion of the trust in his or her gross estate under § 2038 or § 2042, if the settlor had died on September 25, 1985.

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax will not cause the trust to lose its exempt status.

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 paragraph (b)(4)(i)(A), (B), or (C) of this section) 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. 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.

In the present case, Trust is not subject to GST tax because it became irrevocable before September 25, 1985. It is represented that no additions, constructive or otherwise, have been made to the Trust subsequent to that date.

The court construction of the spendthrift clause and provisions of Trust to allow the proposed sales of remainder interests in Trust and the proposed sales of remainder interests in Trust will not shift any beneficial interests in Trust to a lower generation and will not extend the time for vesting of any beneficial interest in Trust beyond the period provided for in the original trust. Accordingly, based upon the facts submitted and the representations made, and pursuant to § 26.2601-1(b)(4)(i)(D), we conclude that the court construction of the spendthrift clause and provisions of Trust to allow the proposed sales of remainder interests in Trust will not affect the exempt status of Trust for GST

tax purposes. Further, the proposed sales of remainder interests in Trust will not affect the exempt status of Trust for GST tax purposes.

We note that, under § 2652(a)(1), Grandchild 4 is the transferor of Trusts 1 and 2 and, thus, the rules under §§ 2631(a) and 2652(a) apply to those trusts.

Ruling 3:

Section 2501 imposes a tax on the transfer of property by gift by an individual. Section 2511 provides that the tax imposed by § 2501 applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect and whether the property is real or personal, tangible or intangible.

Section 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift. Section 2512(b) provides that where property is transferred for less than an adequate consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration is deemed a gift.

Under § 25.2512-5 of the Gift Tax Regulations, in general, the fair market value of remainders transferred by gift is the present value of the remainders determined by use of the appropriate § 7520 actuarial factor.

Section 7520(a) provides that the value of an annuity, any interest for life or a term of years, or any remainder interest or reversionary interest is determined under tables prescribed by the Secretary and by using an interest rate (rounded to the nearest two-tenths of one percent) equal to 120 percent of the applicable federal midterm rate for the month in which the valuation date falls.

In the proposed sales of remainder interests in Trust, the sales price of the remainder interests will equal (1) the fair market value of the Trust assets on the date of sale, (2) multiplied by the § 7520 actuarial remainder factor then in effect, and (3) then multiplied by the fraction representing that portion of the remainder interest subject to the sale. Based upon the facts submitted and the representations made, we conclude that the proposed sales of remainder interests in Trust will not result in any taxable gifts for federal gift tax purposes as to the buyers or sellers of such interests.

Ruling 4:

Section 61 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.

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.

An exchange of property results in the realization of gain or loss under § 1001 if the properties are materially different. Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991). Properties exchanged are materially different if the properties embody legal entitlements "different in kind or extent" or if the properties confer "different rights and powers." Id. at 565. In Cottage Savings, the Supreme Court held that mortgage loans made to different obligors and secured by different homes embodies distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans. Id. In defining what constitutes a "material difference" for purposes of § 1001(a), the Court states 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. Id. at 564-65.

In the present case, the issue is whether the remaindermen of the trust would have the same property interests and legal entitlements as a result of the proposed construction of the spendthrift clause. It is represented that the court will construe the spendthrift clause to be inapplicable to the remainder interest sales. Because the court's construction of the spendthrift clause does not change the property interests and legal entitlements of the remaindermen, it would be consistent with Cottage Savings to find that the remaindermen's interests after the proposed construction of the clause will not differ materially from the remaindermen's interests before the proposed construction of the clause. Thus, the proposed construction of the spendthrift clause would not give rise to a realization of income to the remaindermen or the trust under §§ 61 or 1001.

Ruling 5:

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.

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 1001(e) provides in determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to § 1014, 1015, or 1041 shall be disregarded. The term “term interest in property” means a life interest in property, an interest in property for a term of years, or an income interest in a trust.

Section 1.1001-1(f)(2) provides that the term “term interest in property” does not refer to remainder or reversionary interests in the property itself or other interests in property which will ripen into ownership of the entire property upon termination or failure of a preceding term interest.

Section 1012 generally provides that the basis of property shall be the cost of the property.

Section 1.1012-1(a) defines cost to be the amount paid for the property in cash or other property. In the present case, Greatgrandchildren 2 and 9 bought their remainder interests in the trust from an unrelated third party, Charity 1. Consequently, under § 1012, the basis of each of their respective interests is the amount that each paid for the property. Each would recognize gain from the sale of the remainder interest equal to the difference between the amount realized over the adjusted basis of the remainder interest.

Likewise, with respect to the sales by Greatgrandchildren 10 and 11, the sons of Grandchild 4, of their 12.5% interests in Trust to Trusts 1 and 2, respectively, Greatgrandchildren 10 and 11 bought their remainder interests in Trust from an unrelated third party, Charity 1. Consequently, under § 1012, the basis of each of their respective interests is the amount that each paid for the property. Each would recognize gain from the sale of the remainder interest equal to the difference between the amount realized over the adjusted basis of the remainder interest.

We express no opinion on whether the proposed sales are authorized under Trust or applicable state laws.

Except as specifically ruled herein, we express no opinion on the federal tax consequences of the modification under the cited provisions or under any other provisions of the Code.

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

Sincerely yours,

Lorraine E. Gardner
Senior Counsel, Branch 4
Office of Associate Chief Counsel
(Passthroughs and Special
Industries)

Enclosure

Copy for section 6110 purposes

cc