Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:4 - PLR-118399-99
Date: OCTOBER 31, 2000

Re:

Legend:

Settlor =
Trust Agreement =
Child 1 =
Child 2 =
Child 3 =
Date 1 =
Spouse of Child 1 =
Spouse of Child 3 =
State =

Dear :

This is in response to a letter dated November 9, 1999, and subsequent correspondence, requesting rulings regarding the generation-skipping transfer tax (GSTT) consequences and income tax consequences of a division of trust assets as described below.

Facts

The facts submitted and representations made are as follows: Before September 25, 1985, Settlor executed Trust Agreement, creating an irrevocable trust (Trust) for the benefit of his children, Child 1, Child 2, and Child 3. Since its inception, the principal assets of Trust have been shares of voting stock in one or more closely-held corporations which pay little or no dividend income. Settlor died on Date 1. No property was added to Trust by any transferor after September 25, 1985.

Under paragraph 1., Article I of Trust Agreement, the net income of Trust is to be paid at least quarterly, in equal shares to Child 1, Child 2, and Child 3. If a child dies before Trust terminates, the child's one-third share of income will be paid as the child appoints by will among the child's surviving spouse and the child's lineal descendants and their spouses or surviving spouses. An appointee must be living on the payment date to receive a distribution. Any part of a deceased child's share of income that the child fails to appoint, or any part remaining when all appointees are deceased, will be paid, per stirpes, to that child's lineal descendants living on a payment date, or, if none, per stirpes, to Settlor's lineal descendants living on a payment date.

Under paragraph 2., Article I, Trust will terminate upon the first to occur of the following: (a) the execution of a written agreement, at any time after Settlor's death, of all then acting Trustees who would not receive any part of the trust principal at the termination, to terminate Trust in whole or in part; (b) the death of Settlor's last living lineal descendant; (c) the twenty-first anniversary of the death of the last survivor among specified individuals.

Under paragraph 2., Article I, when Trust terminates, in whole or in part, the terminated part will be distributed in equal shares to Child 1, Child 2, and Child 3. If a child is not then living, the child's one-third share will be distributed as the child appoints by will among those then living of the child's surviving spouse and the child's lineal descendants and their spouses or surviving spouses. Any part of a deceased child's share that the child fails to appoint will be distributed, per stirpes, to that child's then living lineal descendants, or, if none, per stirpes, to Settlor's then living lineal descendants, or, if none, to Settlor's then living brothers, or, if none, to the then living lineal descendants of Settlor's brothers.

Under paragraph 1. of Article II, Trust must have at least two individual trustees, unless there is a corporate trustee. There may be no more than seven individual trustees and one corporate trustee serving at once. An individual trustee may appoint his or her successor. Otherwise, successor or additional trustees must be appointed by the unanimous action of the trustees or, under specified circumstances, by a majority in interest of the adult income beneficiaries.

Child 1, Child 2, Child 3, the Spouse of Child 1, and the Spouse of Child 3 are named as co-trustees and are currently serving.

Paragraph 2(e) of Article II provides that the Trustees' powers will include the following:

> Divisions or Distributions. To make divisions or distributions in cash or in kind, and to allocate undivided interests in property and dissimilar property to different shares. If necessary to value property to be divided or distributed, it shall be valued at its current fair market value.

The Trustees propose to partition Trust equally into three trusts (Subtrusts) so that there will be one Subtrust for the benefit of each of Child 1, Child 2, and Child 3 (and that Child's spouse and lineal descendants). The terms governing each partitioned Subtrust will be identical to the terms under Trust Agreement except that each child (and that child's spouse and lineal descendants) will be the sole beneficiary of a Subtrust.

The partition is authorized under Section 1339.67 of State's Revised Code. The Trustees will commence a proceeding in State court for an order directing the partition pursuant to the statute. Under the terms of the proposed court order to divide Trust into

Subtrusts, the assets of Trust will be allocated in three equal shares to each Subtrust. The three Subtrusts will each receive a pro rata share of each asset of Trust.

Under the terms of the proposed court order, after the partition, the net income of each Subtrust will be paid, at least quarterly, to the child for whom the Subtrust is held. If the child dies before the Subtrust terminates, the net income of the Subtrust will be paid as the child appoints among the child's surviving spouse and the child's lineal descendants and their spouses or surviving spouses. An appointee must be living on the payment date to receive a distribution. Any part of the income the child fails to appoint, or any part remaining when all appointees are deceased, will be paid, per stirpes, to the child's lineal descendants living on a payment date, or, if none, per stirpes, to Settlor's lineal descendants living on a payment date.

Each Subtrust will terminate upon the first to occur of the following: (a) the execution of a written agreement, at any time after Settlor's death, of all then acting "Independent Trustees" to terminate the Subtrust in whole or in part; (b) the death of Settlor's last living lineal descendant; (c) the twenty-first anniversary of the death of the last survivor among specified individuals (the same individuals specified under the term of Trust). If one Subtrust terminates, in whole or in part, under a written agreement of the Independent Trustees, then each of the other Subtrusts must terminate "to the extent of the same fraction or percentage of such [Subtrust's] assets held on the effective date of such partial termination".

Paragraph 2.(a)(iii) of Article I will limit the persons or entities who can be "Independent Trustees" as follows:

> [T]he only persons and/or entities who shall be treated as "Independent Trustees" shall be any person or entity who
>
> would not then be treated under section 672(c) of the Internal Revenue Code of 1986, as amended from time to time, as a "related or subordinate party" with respect to any person who then is eligible to receive any part of the trust principal of any trust then held under this agreement upon termination at such time.

When a Subtrust terminates, in whole or in part, the terminated part will be distributed to the child with respect to whom the Subtrust has been established. If that child is not then living, the Subtrust assets will be distributed as the child appoints among those then living of the child's surviving spouse and the child's lineal descendants and their spouses or surviving spouses. Any part of the Subtrust assets the child fails to appoint will be distributed, per stirpes, to that child's then living lineal descendants, or, if none, per stirpes, to Settlor's then living lineal descendants, or, if none, to Settlor's then living brothers, or, if none, to the then living lineal descendants of Settlor's brothers.

The co-trustees of each Subtrust will be Child 1, Child 2, Child 3, the Spouse of Child 1, and the Spouse of Child 3.

The trustees have requested the following rulings:

1. The proposed partition of Trust will not cause Trust to lose its exempt status for generation-skipping transfer tax purposes under § 1433(a) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, nor will the proposed division into Subtrusts subject either Trust or the resulting Subtrusts to generation-skipping transfer tax (GSTT).

2. Under the provisions of paragraph 2. (a), Article I, of the original Trust Agreement and of Trust Agreement as modified under the proposed court order, any current beneficiary who is a trustee of any trust under Trust Agreement will not be treated as having possessed or as possessing a general power of appointment under §§ 2041(b) or 2514(c).

3. The partition of Trust into three Subtrusts and the pro rata allocation of Trust assets among the Subtrusts will not be a transfer by Child 1, Child 2, or Child 3 that will be subject to gift tax under § 2501.

4. After the partition of Trust, each Subtrust will be treated as a separate taxpayer under § 643(f).

5. The partition of Trust into three Subtrusts and the pro rata allocation of Trust assets among the Subtrusts will not result in the realization by Trust of any income under § 61 and does not result in the realization of any gain or loss under § 1001.

6. After the partition of Trust into three Subtrusts, the assets of the three Subtrusts will have the same basis and same holding periods as the assets had in Trust.

Ruling 1

Law

Section 2601 imposes a tax on each generation-skipping transfer made by a transfer to a skip person.

Under § 1433(a) of the Tax Reform Act of 1986, the generation-skipping transfer tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) of the Tax Reform Act and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to a 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)(1)(v)(A) provides that, except as provided under § 26.2601-1(b)(1)(v)(B), where any portion of a trust remains in the trust after the post-

September 25, 1985, release, exercise, or lapse of a power of appointment over that portion of the trust, and the release, exercise, or lapse is treated to any extent as a taxable transfer under chapter 11 or 12, the value of the entire portion of the trust subject to the power that was released, exercised, or subject to a lapse is treated as if that portion had been withdrawn and immediately retransferred to the trust at the time of the release, exercise, or lapse.

Section 26.2601-1(b)(1)(v)(B) provides a special rule for certain powers of appointment. This section provides that the release, exercise, or lapse of a power of appointment (other than a general power of appointment as defined in § 2041(b)) will not be treated as an addition to a trust if -- (1) such power of appointment was created in an irrevocable trust that is not subject to Chapter 13 under § 26.2601-1(b)(1), and (2) in the case of an exercise, such power of appointment is not exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date of creation of the trust, extending beyond any life in being at the date of creation of the trust plus a period of 21 years.

In general, any modification or reformation of a trust that was irrevocable on September 25, 1985, that changes the quality, value, or timing of any beneficial interest under the trust, will cause the trust to lose exempt status for GSTT purposes.

Under § 2652(a)(1), for generation-skipping transfer tax purposes, the term “transferor” means (A) in the case of any property subject to estate tax, the decedent, and (B) in the case of any property subject to gift tax, the donor. An individual will be treated as transferring any property with respect to which such individual is the transferor.

Analysis

Trust was irrevocable prior to September 25, 1985. You represent that there have been no constructive or actual additions to Trust since September 25, 1985.

The trustees will allocate the assets of Trust in equal shares to the three Subtrusts. The three Subtrusts will each receive a pro rata share of each asset of Trust.

The dispositive provisions under the proposed court order that will govern the Subtrusts are identical to those under Trust Agreement. In particular, the income of each Subtrust will be paid as provided in Trust Agreement, each Subtrust will terminate at the same time as provided in Trust Agreement and will be distributed under the same terms as provided in Trust Agreement.

Each Subtrust can be terminated by agreement of the Independent Trustees. However, the only persons or entities who can be an Independent Trustee are persons or entities who would not be related or subordinate within the meaning of § 672(c) to any person then eligible to receive any part of the principal of any trust then held under Trust Agreement as modified under the court order if a Subtrust terminated at that time.

Thus, a child for whom a Subtrust is held cannot, as trustee, participate in a decision to terminate any Subtrust in whole or in part.

Accordingly, based on the facts submitted and the representations made we conclude that the proposed partition of Trust will not be considered a modification that affects the quality, value, or timing of any powers, beneficial interests, rights or expectancies originally provided for under Trust Agreement. Accordingly, the proposed partition of Trust will not cause Trust to lose its exempt status for generation-skipping transfer tax purposes under § 1433(a) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, nor will the proposed division into Subtrusts subject either Trust or the resulting Subtrusts to generation-skipping transfer tax (GSTT).

Ruling 2

Under § 2041(a)(2), the value of the gross estate shall include the value of all property to the extent of any property with respect to which the decedent has, at the time of death, a general power of appointment created after October 21, 1942.

Section 2041(b)(1) defines "general power of appointment" as a power which is exercisable in favor of the decedent, his estate, his creditors, or creditors of his estate. However, under § 2042(b)(1)(A), a power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent is not a general power of appointment.

Under § 2514(b), the exercise or release of a general power of appointment created after October 21, 1942, is deemed the transfer of property by the individual possessing such power.

Under § 2514(c), "general power of appointment" is generally defined for gift tax purposes as the term is defined for estate tax purposes under § 2041(b).

In this case, the testamentary powers of appointment granted to Child 1, Child 2, and Child 3 under Trust Agreement and under Trust Agreement as modified by the proposed court order, are exercisable only in favor of the child's surviving spouse, the child's issue, and their spouses. Thus, under § 2041(b) and § 2514(c), each child's power of appointment is not a general power of appointment.

Under paragraph 2. (a), Article I of Trust Agreement, Trust can be terminated, in whole or in part, upon the execution of a written agreement, at any time after Settlor's death, of all trustees who would not receive any part of the trust principal at the termination. Under this provision, any current beneficiary who is a trustee of Trust would be precluded from participating in a decision to terminate Trust and from thereby causing a distribution of principal to him or herself.

Under the terms of paragraph 2. (a) of Article I as modified by the proposed court order, only "Independent Trustees" will be able to participate in a decision to terminate

a Subtrust in whole or in part by execution of a written agreement at any time after Settlor's death. An agreement of the Independent Trustees to terminate one Subtrust will cause a proportionate termination of the other Subtrusts. The only persons or entities who will qualify as Independent Trustees are those who would not then be related or subordinate (within the meaning of § 672(c)) to any person then eligible to receive any part of the trust principal of any trust upon termination of that trust. Thus, any current beneficiary who is a trustee of a Subtrust would be precluded from participating in a decision to terminate any Subtrust and from thereby causing a distribution of principal to him or herself.

Accordingly, based on the facts submitted and representations made, we rule that, under the provisions of paragraph 2. (a), Article I, of the original Trust Agreement and of Trust Agreement as modified under the proposed court order, any current beneficiary who is a trustee of any trust under Trust Agreement will not be treated as having possessed or as possessing a general power of appointment under §§ 2041(b) or 2514(c).

Ruling 3

Section 2501 of the Code provides for a gift tax on the transfer of property by gift. Section 2511 of the Code provides that the gift tax imposed by section 2501 shall apply 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.

In this case, as discussed above, the interest of each beneficiary will remain the same after the proposed partition. Accordingly, based on the facts submitted and the representations made, we conclude that the partition of Trust into three Subtrusts and the pro rata allocation of Trust assets among the Subtrusts will not be a transfer by Child 1, Child 2, or Child 3 that will be subject to gift tax under § 2501.

Ruling 4

Section 643(f) provides that, under regulations to be prescribed by the Secretary, two or more trusts shall be treated as one trust if: (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries; and (2) a principal purpose of such trusts is the avoidance of federal income tax.

Although each Subtrust will have the same grantor, the Subtrusts will have different primary beneficiaries. Therefore, based upon the facts submitted and representations made, we conclude that each of the Subtrusts will be treated as a separate trust under § 643(f) for federal income tax purposes.

Ruling 5

Section 61(a)(3) of the Code provides that gross income includes gains derived from dealings in property.

Section 1001(a) of the Code 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 1.1001-1(a) of the Income Tax Regulations provides that except as otherwise provided in subtitle A of the Code, the gain or loss realized from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

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, but do not acquire a new or additional interest as a result thereof. Thus, neither gain nor loss is realized on a partition. See Rev. Rul. 56-437, 1956-2 C.B. 507.

In Rev. Rul. 69-486, 1969-2 C.B. 159, distinguished by, Rev. Rul. 83-61, 1983-1 C.B. 78, a non-pro rata distribution of trust property was made in kind by the trustee, although the trust instrument and local law did not convey authority to the trustee to a make a non-pro rata distribution of property in kind. The distribution was effected as a result of a mutual agreement between the trustee and the beneficiaries. Because neither the trust instrument nor local law conveyed authority to the trustee to make a non-pro rata distribution, Rev. Rul. 69-486 held that the transaction was equivalent to a pro rata distribution followed by an exchange between the beneficiaries and was subject to the provisions of § 1001 and § 1002 of the Code.

The present case is distinguishable from Rev. Rul. 69-486 because the assets of Trust will be allocated pro rata among the three Subtrusts. Accordingly, the proposed transaction will not be treated as a pro rata distribution followed by an exchange of assets among the beneficiaries of the three original trusts.

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 of the Code. 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 Supreme Court in Cottage Savings, 499 U.S. at 560-61, concluded that § 1.1001-1 of the regulations 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."

In defining what constitutes "materially different" for purposes of § 1001(a), the Court stated that properties are "different" in the sense that is "material" 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.

It is consistent with the Supreme Court's opinion in Cottage Savings to find that the interests of the beneficiaries of the three Subtrusts will not differ materially from their interests in Trust. The proposed transaction will not change the interests of the beneficiaries. Instead, the beneficiaries will be entitled to the same benefits after the proposed transaction as before. The proposed transaction is similar to the kinds of transactions discussed in Rev. Rul. 56-437, since Trust is to be partitioned, but all other provisions of Trust will remain unchanged, other than changes described above which are necessary to ensure that the beneficiaries of Trust will be entitled to the same benefits under the three Subtrusts. Thus, the proposed transaction will not result in a material difference in the kind or extent of the legal entitlements enjoyed by the beneficiaries.

Therefore, the partition of Trust into three Subtrusts and the pro rata allocation of each existing asset among the three Subtrusts will not result in the realization by Trust of any income under § 61 of the Code and does not result in the realization of any gain or loss under § 1001 of the Code.

Ruling 6

Section 1015(b) provides that, if a property is acquired by a transfer in trust (other than by a transfer in trust by a gift, bequest, or devise), the basis shall be the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor on the transfer.

Section 1.1015-2(a) provides that, in the case of property acquired by transfer in trust (other than by a transfer in trust by a gift, bequest, or devise) the basis of property so acquired is the same as it would be in the hands of the grantor increased by the amount of gain or decreased by the amount of loss recognized to the grantor on the transfer under the law applicable to the year in which the transfer was made. In addition, the principles in § 1.1015-2(b) concerning the uniform basis are applicable in determining the basis of property where more than one person acquires an interest in property by transfer in trust. Section 1.1015-2(b) provides that property acquired by gift has a single or uniform basis although more than one person may acquire an interest in the property. The uniform basis of the property remains fixed subject to proper adjustment for items under §§ 1016 and 1017.

Because § 1001 will not apply to the proposed partition of Trust, the basis of the assets in the Subtrusts will be the same as the basis of the assets currently held in Trust.

Section 1223(2) of the Code provides that in determining the period for which the taxpayer has held property however acquired, there shall be included the period for which the property was held by any other person, if under Chapter 1 of the Code such property has, for the purposes of determining gain or loss from a sale or exchange, the

same basis in whole or in part in the taxpayer's hands as it would have in the hands of such other person.

Accordingly, based on the facts submitted and the representations made, we conclude that, after the partition of Trust into three Subtrusts, the basis and holding periods of the assets held in the three Subtrusts will be the same as the basis and holding periods of the assets when held in Trust.

Except as specifically ruled herein, we express no opinion on the federal tax consequences of the transaction 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,
George L. Masnik, Chief, Branch 4
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure
Copy for section 6110 purposes