Internal Revenue Service

Department of the Treasury

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Person to Contact:

199912034

Telephone Number:

Refer Reply to:
CC:DOM:P&SI:4/PLR-102240-98

Date:
DEC 28 1998

Re:

Legend:

Grantor -
Child 1 -
Child 2 -
Child 3 -
Trust -

Trustee -

Dear

This is in reference to the letter dated requesting rulings regarding the effect of the proposed judicial modification of the trust instrument for federal income tax and generation-skipping transfer (GST) tax purposes.

In , Grantor created an irrevocable trust (Trust) for the benefit of his children and their issue. The Trust was modified in to give both corporate and individual trustees full authority to participate in the management of the Trust, remove the provision requiring a minimum of three trustees, limit the number of trustees to one corporation and three individuals, and to prohibit any beneficiary of the Trust from participating, directly or indirectly, in any decision to make discretionary distributions to himself or herself while the beneficiary is a shareholder of, or a director, officer or employee of the Trustee. The sole current trustee is Trustee, a corporation in which Grantor has no ownership or management interest and is not an officer or director.

The dispositive provisions of the Trust are governed by provides that the trustee will divide the income from the trust (referred to in the instrument as the "A Trust") into equal shares for designated children, any

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later designated children, or the surviving issue of any predeceased designated child, and distribute the income quarterly to or for the benefit of each beneficiary. The trustee has sole discretion to distribute any amount of principal from the "A Trust" to any income beneficiary for that beneficiary's maintenance, support and education. Discretionary distributions of principal do not have to be equal among the beneficiaries and do not reduce the recipient's share of the income of the "A Trust." No trust beneficiary, whether a shareholder of Trustee or while serving as a director, officer, or employee of Trustee, or while serving as an individual trustee of the trust, may participate, directly or indirectly, in any decision pertaining to discretionary distributions of principal to himself or herself. Under , Grantor's spouse may designate additional children who are issue of or legally adopted by the Grantor, as beneficiaries of Trust. However, any designation of an individual who was legally adopted by Grantor must become effective prior to Grantor's 61st birthday.

also provides that, when each income beneficiary of "A Trust" reaches age , the trustee will establish a separate "B Trust" for that beneficiary and set aside, in that "B Trust," one-fourth of the principal of the "A Trust" from which that child is entitled to receive income distributions. Likewise, when each beneficiary reaches age , the trustee will transfer to that beneficiary's "B Trust," one-third of the remaining "A Trust" principal (adjusted to take into account variations in value and prior distributions) from which that child was entitled to receive quarterly income distributions. The individual beneficiaries of each "B Trust" have the right to withdraw the entire principal of that "B Trust" at the time it is funded. If they do not exercise that right at that time, the withdrawal right will lapse.

If the beneficiary does not withdraw the principal of the "B Trust," the trustee will distribute the income of the "B Trust" quarterly to the beneficiary and as much of the principal as the trustee, in its sole discretion, deems necessary for the beneficiary's maintenance or support. Upon the death of each child, the trustee will distribute the income and principal to or for the benefit of that child's issue pursuant to the child's exercise of a testamentary special power of appointment. In the event the child does not exercise the power, the income and principal will be distributed to that child's issue, per stirpes. If there are no issue, the income and principal will be distributed to that child's surviving spouse pursuant to a direction by the child; otherwise, any remaining principal and income will be distributed to the "A Trust."

Each beneficiary's share of the "A Trust" income will be adjusted based on distributions of principal to: 1) that child's "B Trust;" 2) that child's issue or surviving spouse upon that child's death before reaching age and 3) that child's issue under the provision in discussed below.

provides that, unless terminated earlier as described below, the "A Trust" will terminate upon the last to occur of: 1) the death of all the Grantor's children who are the income beneficiaries; 2) the Grantor's death; or 3) the death of Grantor's surviving spouse, if she was entitled to receive income from the "A Trust." provides that, prior to such termination date, when Grantor's first grandchild reaches age the remaining principal of the "A Trust" will be divided into equal shares, one for each current income beneficiary of the "A Trust," on a per stirpital basis, and a per stirpital share for each income beneficiary who died before attaining age Each grandchild, upon attaining age will be paid a portion of his or her per stirpital share of the divided shares of the "A Trust." Upon termination of the "A Trust," principal and accrued income will be distributed to the living issue of Grantor's children who were entitled to receive income in the same proportion as the issue would have been entitled to receive income if the "A Trust" had not terminated.

provides that Trust and any other trust created thereunder will terminate, if not earlier terminated, no later than 21 years after the death of the survivor of seven specified persons who are related to Grantor.

provides that no individual trustee shall participate in any decision to authorize discretionary payments of income or principal to or for the benefit of himself, herself, or anyone he or she is legally obligated to support.

provides that all questions pertaining to the validity, construction and administration of any trust created thereunder shall be determined in accordance with New York law. However, under the individual trustees have the power to change the situs, which was originally , of the "A Trust", or any other trust created thereunder if, in their sole and absolute discretion, the change is in the best interest of the trust or its beneficiaries or the change will facilitate trust administration. Although, the current situs of the Trust is the Trust continues to be governed by New York law.

Grantor has three children; Child 1, Child 2, and Child 3 . They are the current income beneficiaries of the "A Trust." Upon reaching age , both Child 1 and Child 2 elected to withdraw the entire principal that had been distributed to each child's "B Trust."

You represent that there have been no additions, actual or constructive, to the Trust after September 25, 1985.

Proposed Transaction

The Trustee proposes to seek judicial approval in the appropriate local court for division of the "A Trust" into subtrusts The court will apply the laws of the State of New York in its proceedings, as required by the terms of Trust. Upon court approval, the assets of the "A Trust" will be allocated pro rata to the subtrusts. You represent that, for purposes of making the pro rata allocation of Trust assets to the successor subtrusts, identical assets with different adjusted bases will be treated as different assets. Each subtrust will be held and managed separately by Trustee in trust for the primary benefit of one of the Grantor's children and their issue,

If, under Grantor's spouse designates additional beneficiaries of the Trust, then each existing subtrust will transfer a pro-rata portion to a new subtrust for the benefit of the subsequently-designated beneficiary. The creation and funding of any additional subtrust will be executed in the same manner as the existing subtrusts. The dispositive provisions of the new subtrusts will be consistent with the terms of the existing subtrusts.

With the exception of the beneficiaries, the terms of each of the subtrusts will be identical. The terms of the subtrusts will include all the provisions of the "A Trust." Except for the provisions involving calculation of each child's share of the "A Trust" and the funding of the "B Trust," each subtrust will be governed by the dispositive provisions of of the Trust applicable to the "A Trust" and "B Trust," as modified by the agreement and proposed court order.

Each subtrust will provide for an "A Trust" from which income will be distributed to the primary beneficiary or a subsequently-designated beneficiary) with the trustee retaining sole discretion to distribute principal to the income beneficiary for that beneficiary's maintenance, support and education. To the extent that Trustee exercises its discretionary authority to distribute principal to an income beneficiary of a "A Trust" subtrust, each distribution will be funded by drawing a pro-rata share of the distribution from each of the then-existing subtrusts to ensure that each distribution will be funded equally from each of the existing or additional subtrusts. In addition, the "A Trust" subtrust will contain the same distribution provisions currently provided in of the Trust when the Grantor's first grandchild reaches age (upon the first grandchild of the Grantor reaching age the remaining principal of each of the "A Trust" subtrusts is to be divided into as many parts as there

are parts sharing income of the "A Trust" subtrust and each grandchild of the Grantor, upon reaching age , will receive one-half of his or her per stirpital share of the principal of the respective "A Trust" subtrust.)

Each subtrust will be governed by the same provisions in of Trust for establishing a "B Trust" portion when the primary beneficiary reaches the applicable age. To the extent that any "B Trust" has been established for any primary beneficiary, a "B Trust" portion of the respective subtrust will be established, funded, and administered consistent with the provisions of of Trust.

The "A Trust" portion of each subtrust will terminate upon the last to occur of: 1) the death of the last survivor of Grantor's children who are the income beneficiaries; 2) the Grantor's death; or 3) the death of Grantor's surviving spouse, if she was entitled to receive income from the "A Trust."

The "B Trust" portion of each subtrust will be distributed pursuant to the exercise of a testamentary special power of appointment held by the primary beneficiary of each "B Trust," or, in the event of nonexercise, to that child's issue, per stirpes. If there are no issue, the income and principal will be distributed to that child's surviving spouse pursuant to a direction by the child; otherwise, any remaining principal and income will be distributed equally to the "A Trust" portion of each subtrust.

Upon termination of each subtrust, principal and any undistributed income will be paid among the living issue of the primary beneficiary of that subtrust. If there are no living issue, the principal and undistributed income will be paid in equal parts to the other remaining subtrusts.

In no event may any subtrust continue beyond the date that is 21 years after the death of the survivor of the seven persons specified in the Trust who are related to Grantor.

Each of the subtrusts will be administered under the laws of the State of New York. You represent that the proposed partition is authorized under the laws of New York. Specifically, §§ 7-1.13(a)(2) and (c) of the New York Estates, Powers and Trusts Laws (E.P.T.L.) provide that:

> (a)(2) The trustee of an express trust may divide such trust into two or more separate trusts, with the consent of all persons interested in the trust but without prior court approval, for any reason which is not directly contrary to the primary purpose of the trust.
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> * * *
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> (c) . . . [T]he terms of the disposing instrument, subject to modifications approved by the court, shall govern each separate trust established hereunder, except that separate trusts for one or more members of a class of beneficiaries may be established under [(a)(2)] without modification by the court if the property held in trust is distributed to such separate trusts for one or more members of such class on the basis of share per stirpes, per capita, or by representation, wichever is consistent with the terms of the disposing instrument.

You request rulings that:

1. The proposed division of the Trust will not cause the Trust to lose its exempt status for generation-skipping transfer tax purposes under § 1433(b)(2)(A) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i), nor will the proposed division into subtrusts subject either the Trust or the resulting subtrusts to the generation-skipping transfer tax.

2. The subtrusts will be treated as separate trusts for federal income tax purposes.

3. Neither the proposed division nor the distribution of assets to the subtrusts will result in recognition of gain or loss to the Trust, the subtrusts, or the beneficiaries of the Trust or the subtrusts.

Issue 1:

You request rulings that the proposed partition of the Trust pursuant to the terms of the petition, will not result in either the Trust or the subtrusts created by the partition being subject to the generation-skipping transfer tax imposed under § 2601.

Section 2601 imposes a tax on every generation-skipping transfer made after October 26, 1986.

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 GST tax provisions do not apply to any generation-skipping transfer under a trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985. However, this exemption does not apply to additions (actual or constructive) that are made to the trust after September 25, 1985.

Section 26.2601-1(b)(1)(iv) provides that if an addition is made after September 25, 1985, to an irrevocable trust that is otherwise exempted from the application of Chapter 13 (the GST tax) by § 1433(b)(2)(A) of the Act, a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the provisions of Chapter 13.

You have represented that the Trust was irrevocable on September 25, 1985, and no additions have been made to the Trust after that date.

A modification of a trust that is otherwise exempt for GST tax purposes under the 1986 Act will generally result in a loss of its "grandfathered" exempt status if the modification changes the quality, value, or timing of any powers, beneficial interests, rights or expectancies originally provided for under the terms of the trust.

Under the proposed partition of the Trust, the trustee of the subtrusts will continue to be governed by the same trustee provisions currently in the Trust. The terms of the proposed partition ensure that, if there is any beneficiary that is subsequently designated as such by the Grantor's spouse, that beneficiary will receive a proportionate share of the interests in each of the current subtrusts and that the rights of that beneficiary will be the same as the other previously designated beneficiaries. The terms of the proposed partition also ensure that any discretionary distribution by the trustee(s) to any beneficiary will be limited to a standard based on maintenance, support, and education of the beneficiary and will be funded equally from all subtrusts in existence at that time. Each of the subtrusts, under the terms of the partition, will terminate at the same time. Thus, each of the subtrusts will have substantive terms identical to those of the original trust and the parties' beneficial interest will not change.

We conclude that the proposed partition will not alter the quality, value or timing of any powers, or beneficial interests, rights or expectancies originally provided for under the terms of the Trust. Therefore, the partition, as proposed, will not subject the Trust, or any trust created under its terms, to the generation-skipping transfer tax.

Accordingly, the terms of the Trust, as proposed to be modified pursuant to the terms of the petition, will not affect the GST status of the Trust and, thus, will not result in a transfer of property that will subject the Trust to the generation-skipping transfer tax imposed under § 2601. In addition, the proposed partition of the Trust into subtrusts will not subject the subtrusts to the generation-skipping transfer tax.

Issue 2:

The Subtrusts that are created as a result of the division are created as of the date of the division and, therefore, are subject to section 643(f) of the Code. 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.

While the Subtrusts will have the same grantor, they will have different primary beneficiaries. Provided that each of the Subtrusts is separately managed and administered, each of the Subtrusts will be treated as a separate trust for federal income tax purposes.

Issue 3:

You request a ruling that the division of the Trust into separate successor subtrusts and the division of the Trust's assets among the successor subtrusts on a pro rata basis will not constitute a taxable disposition of the trust assets for purposes of § 1001 and will therefore not result in gain or loss to the Trust, the successor subtrusts, or the beneficiaries of any of these trusts.

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 § 1011 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 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.

A partition of jointly owned property is not a sale of 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 the partition. See Rev. Rul. 56-437, 1956-2 C.B. 507.

In Rev. Rul. 69-486, 1969-2 C.B. 159, a non-pro rata distribution of trust property was made in kind by the trustee, although the trust instrument and local law did not give the trustee authority to make a non-pro rata distribution of property in kind. The distribution was effected as a result of a mutual agreement among the trustees 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.

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. 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 mortgage loans were considered "substantially identical" by the agency that regulated the financial institution.

In Cottage Savings, the Supreme Court concluded that § 1.1001-1 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 a "material difference" for purposes of § 1001(a), the Supreme Court stated that properties are "different" in a sense that is "material" to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent. Cottage Savings, at 564-565. The Supreme Court held that mortgage loans made to different obligors and secured by different homes embodied distinct legal entitlements, and that the taxpayer realized losses when it exchanged the loans.

It is consistent with the Supreme Court's opinion in Cottage Savings to find that the interests of the beneficiaries of the successor subtrusts will not differ materially from their interests in the Trust. The proposed transaction will not change the interests of the beneficiaries, who 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 the Trust is to be partitioned, but all other provisions of the Trust will apply to determine the beneficiaries' respective interests in the successor subtrusts. Thus, the transaction will not result in a material difference in the kind or extent of the legal entitlements enjoyed by the beneficiaries. The conclusion that the proposed partition will not result in a material change is unaffected by the fact that it is anticipated that after the partition, the trustees of the successor subtrusts may cause the subtrusts to invest in dissimilar assets.

Therefore, the Trust, the successor subtrusts, and the beneficiaries of any of these trusts will not realize gain or loss under § 1001 as a result of the proposed transaction.

Accordingly, the division of the Trust into separate subtrusts and the division of the assets among the new subtrusts on a pro rata basis will not constitute a taxable disposition of the trust assets for purposes of § 1001 and will therefore not result in gain or loss to the Trust, the successor subtrusts, or the beneficiaries of any of these trusts.

Except as we have specifically ruled herein, no opinion is expressed concerning the federal tax consequences of the transaction described above under the cited provisions of the Code, including the application of § 673 through § 677, or any other provision of the Code .

This ruling is based on the facts presented and the applicable law in effect on the date of this letter. If there is a change in material fact or law (local or federal) before the

transactions considered in this ruling take effect, the ruling will have no force or effect.

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

Sincerely,

Assistant Chief Counsel
(Passthroughs and Special
Industries)

(signed) George L. Masnik

By _____
George Masnik
Chief, Branch 4

Enclosure
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