

Internal Revenue Service

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Department of the Treasury

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Date: January 3, 2000

Re:

Legend:

Settlor =

Settlor's Spouse =

Trust Agreement =

Child 1 =

Child 2 =

Child 3 =

Child 4 =

Trust 1 =

Trust 2 =

Trust 3 =

Trust Company =

New Trust Agreement =

Settlor's Father-In-Law =

Dear :

This is in response to a letter dated July 15, 1999, and subsequent correspondence, submitted on behalf of Trust 1, Trust 2 and Trust 3, requesting rulings regarding the generation-skipping transfer tax (GSTT) consequences and income tax

consequences of a division of trust assets as described below.

Facts

Before September 25, 1985, Settlor executed Trust Agreement, creating a separate irrevocable trust, Trust 1, Trust 2, Trust 3 and Trust 4, for each of his then living children, Child 1, Child 2, Child 3, and Child 4, respectively. The terms of the four trusts are substantially identical. Child 4 died without issue, and the property in his trust was divided equally among the trusts for Child 1, Child 2, and Child 3.

Under Article Three of Trust Agreement, during the life of the child for whom a trust is held, the trustee of that child's trust has absolute discretion to distribute to the child any part of the trust income or principal for the child's best interests and general welfare, considering the child's accustomed standard of living, without regard to other resources available to the child. During each child's lifetime, the child has the power to appoint any part of the principal of the child's trust to any of the child's issue.

At the death of each child, the principal of the child's trust will be distributed to any persons, excluding the child's estate, creditors, and creditors of the child's estate, as the child may appoint under the child's will. Any principal of a deceased child's trust that the child fails to appoint will be held in a single, separate trust for the child's spouse, then living children, and issue of the child's deceased children (the "Child's Family Trust"). If a child of Settlor dies without issue, the child's trust will be divided equally among the trusts for Settlor's then living children, or, if there are no children of Settlor then living, the trust will be distributed among Settlor's heirs at law.

Section A of Article Four provides for the administration of each Child's Family Trust held for the spouse, children, and issue of deceased children of a deceased child of Settlor. The trustee of each Child's Family Trust has absolute discretion to pay any amounts of trust income or principal to any among the class of beneficiaries from time to time living for the distributee's support in reasonable comfort, considering their accustomed standards of living, taking into account the income and other resources known to the trustee.

The "distribution date" of a Child's Family Trust is the later of the date on which the Child's Family Trust is to be established and the date, after the death of the deceased child's spouse, on which none of the deceased child's living children are under age 25. On the distribution date of a Child's Family Trust, the remaining trust assets will be divided into separate

shares for the deceased child's then living issue, per stirpes. Each share will be distributed outright unless the trustee determines it is in the best interest of a beneficiary to retain a share in trust for a beneficiary (a "Descendant's Trust"). If there are no then living issue of the deceased child, the Child's Family Trust will be divided among trusts for the then living issue of Settlor, or, if there are no such issue, then among Settlor's heirs at law.

Under Section B of Article Four, the trustee of each Descendant's Trust has absolute discretion to pay any amounts of trust income or principal to the trust beneficiary for the beneficiary's support in reasonable comfort, considering their accustomed standards of living, taking into account the income and other resources known to the trustee. The trustee may distribute a Descendant's Trust to its beneficiary at any time or, at the beneficiary's death, distribute the remainder among the beneficiary's then living issue, per stirpes, or, if none, among the then living issue of the beneficiary's most immediate ancestor who was an issue of Settlor, per stirpes, or, if none, among Settlor's then living issue, per stirpes, or, if none, among Settlor's heirs at law.

Under Section C of Article Eight, no assets can be held in trust more than 20 years after the death of the last survivor of Settlor's issue living at the date of execution of Trust Agreement. At the end of that period, all assets held in any trust will vest in the beneficiaries of the trust and be paid to them within one year.

Settlor's Spouse is designated as the initial trustee of the trusts created under Trust Agreement. Under Section A of Article Nine, four individuals and Trust Company are designated as consecutive successor trustees, if any trustee ceases to act without designating a successor who serves as trustee. Each individual trustee may designate one or more successors to act, one at a time. Each individual acting as sole trustee may also designate a co-trustee which may be an individual or a trust company or bank authorized to transact trust business and which has a capital and surplus of not less than 10 million dollars.

Under Section C of Article Nine, each successor trustee has the same rights, powers, and authority as every trustee. Under Sections D and E, each trustee is authorized to resign for any reason and may resign as trustee, or renounce a trusteeship before qualifying for it, of some trusts but remain trustee of other trusts held under Trust Agreement.

Currently, Child 1 and Child 3 are the trustees of Trusts 2 and 3. Child 1 and Child 1's Spouse are the trustees of Trust 1.

Under Section C of Article Ten, a trustee of any trust created under Trust Agreement who is also a beneficiary of that trust is prohibited from participating in any decision to pay or apply trust income or principal for the trustee-beneficiary's own benefit or to discharge that trustee-beneficiary's legal obligation of support.

Under Section B.2 of Article Twelve, any special power of appointment granted under the instrument cannot be exercised directly or indirectly for the donee's pecuniary benefit, to satisfy any legal obligation of the donee, or otherwise in favor of the donee, the donee's creditors, the donee's estate, or the creditors of the donee's estate.

It is represented that no additions, actual or constructive, have been made to any of Trusts 1, 2, or 3 since September 25, 1985, and that none of the trusts have been amended or otherwise altered since that date.

Trusts 1, 2, and 3 currently hold realty and intangible non-realty assets. The Settlor proposes to execute New Trust Agreement with dispositive provisions identical to those of Trust Agreement. Certain provisions governing the administration of the trusts will be modified. Under New Trust Agreement, New Trusts 1, 2, and 3 ("New Trusts") will be created for the benefit of Child 1, Child 2, and Child 3, respectively. The trustees of each of Trust 1, 2, and 3 will transfer that trust's intangible non-realty assets to the corresponding New Trust.

Articles II and III of New Trust Agreement contain the provisions for New Trusts 1, 2, and 3 for Child 1, Child 2, and Child 3, respectively, as well as the provisions for each Child's Family Trust and for each Descendant's Trust. As noted, the dispositive provisions with respect to these trusts are identical to those of existing Trusts 1, 2, and 3.

Under Article V, of New Trust Agreement, each trust established under the agreement has an Independent Trustee, a Non-Independent Trustee, and a Protector. Under the terms of the trusts, only the Independent Trustee is authorized to make discretionary distributions of income and principal. The initial Independent Trustee and Protector will be designated under New Trust Agreement. Whenever a new trust comes into existence under the terms of New Trust Agreement, the then serving Independent Trustee and Protector will continue to serve. The Protector of each trust can remove and replace the Independent Trustee and appoint successor Independent Trustees. Each Independent Trustee can designate a successor, but the designation will be void if the Protector has appointed a successor. If no Independent Trustee is serving and no successor has been appointed, all of the income beneficiaries of the subject trust who have reached

age 21 can appoint a successor Independent Trustee by majority vote. Any successor Independent Trustee cannot be related or subordinate, within the meaning of § 672(c), with respect to any lineal descendant of Settlor.

The Non-Independent Trustee of each trust must be Settlor's child or grandchild with respect to whom the trust is created. If the grandchild has not reached age 30, the Independent Trustee can appoint another person to act as Non-Independent Trustee until the grandchild reaches age 30, preferably a family member of Settlor, Settlor's Spouse, or Settlor's children. However, any Non-Independent Trustee so appointed must be a lineal descendant of settlor's father-in-law. Each Non-Independent Trustee can designate a successor. In addition, each Non-Independent Trustee (except Child 2) may designate an additional Non-Independent Trustee and may remove and replace any such additional Non-Independent Trustee.

The child, or the grandchild, if age 30 or over, with respect to whom a trust is created may remove and replace an acting Protector. In addition, if the Protector ceases to serve, the child, or grandchild age 30 or over, may appoint a successor Protector. If a Grandchild is under age 30, a Protector who ceases to serve may appoint a successor. However, any successor Protector cannot be a related or subordinate party under § 672(c) of the Code, with respect to any beneficiary of a trust. With respect to New Trust 2 for the benefit of Child 2, the Protector for the trust must be a lineal descendant of Settlor's Father-in-law, but cannot be a related or subordinate party under § 672(c) with respect to Child 2.

Under New Trust Agreement, neither the four individuals designated as successor trustees under Trust Agreement nor Trust Company are designated as a successor trustee.

Further, it is represented that the initial Independent Trustee will not be related or subordinate, within the meaning of § 672(c), to any lineal descendant of Settlor. In addition, it is represented that the initial trust Protector will not be related or subordinate, within the meaning of § 672(c), to any beneficiary of a trust.

Generation-Skipping Transfer Tax

Law

Section 2041(b) provides that the term "general power of appointment" means a power that is exercisable in favor of the individual possessing the power, his estate, his creditors, or the creditors of his estate. Under § 2041(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.

Section 20.2041-1(c)(1) of the Estate Tax Regulations provides that a power of appointment is not a general power if by its terms it is either: (a) exercisable only in favor of one or more designated persons or classes other than the decedent or his creditors, or the decedent's estate or the creditors of his estate; or (b) expressly not exercisable in favor of the decedent or his creditors, or the decedent's estate, or the creditors of his estate. Under § 20.2041-1(c)(2), a power is limited by an ascertainable standard if the extent of the holder's duty to exercise and not to exercise the power is reasonably measurable in terms of his needs for health, education, or support (or any combination of them). The words "support" and "maintenance" are synonymous and their meaning is not limited to the bare necessities of life.

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 lapsed 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.

Rev. Rul. 95-58, 1995-2 C.B. 191 concludes that a settlor's retained power to remove a trustee and appoint an individual or corporate trustee or successor that is not related or subordinate to the settlor (within the meaning of § 672(c)), will not be considered retention of the trustee's discretionary powers for purposes of §§ 2036 and 2038.

Analysis

Trusts 1, 2, and 3 were irrevocable prior to September 25, 1985. You represent that there have been no constructive or actual additions to Trusts 1, 2, and 3 since September 25, 1985.

The dispositive provisions under New Trust Agreement are identical to those under Trust Agreement. The trustees of each of Trusts 1, 2, and 3 will transfer that trust's intangible non-realty assets to the corresponding New Trust held for the benefit of the same child of Settlor and the child's issue.

Certain provisions under New Trust Agreement, governing the administration of the trust and appointment of successor trustees, differ from those under Trust Agreement. Article V of New Trust Agreement provides for an Independent Trustee who, alone, can make discretionary income and principal payments to the beneficiaries of any trust, in addition to managing trust assets. Article V also provides for a Non-Independent Trustee who can manage trust assets and appoint additional Non-Independent Trustees as well as successor Non-Independent Trustees. In addition, the trustee provisions under New Trust

Agreement provide for a trust Protector with the power to remove and replace any serving Independent Trustee and appoint successor Independent Trustees. Trust Agreement does not contain a mechanism for the removal and replacement of trustees. Finally, the trustee provisions under New Trust Agreement do not designate as successor trustee Trust Company or the individuals designated under Trust Agreement.

Under the trustee provisions in New Trust Agreement, the child, or grandchild over age 29, for whom a trust is designated will be the Non-Independent Trustee of the trust. As Non-Independent Trustee, a beneficiary cannot make discretionary payments for the beneficiary's benefit or for the benefit of any other beneficiary. Thus, the appointment of a child, or a grandchild over age 29, as Non-Independent Trustee of a trust will not confer any additional powers or beneficial interests upon any of the beneficiaries.

Further, it is represented that the initial Independent Trustee will not be related or subordinate, within the meaning of § 672(c), to any lineal descendant of Settlor and that the initial trust Protector will not be related or subordinate, within the meaning of § 672(c), to any beneficiary of a trust. Under Article V no successor Independent Trustee will be related or subordinate, within the meaning of § 672(c), to any lineal descendant of Settlor and no successor trust Protector will be related or subordinate, within the meaning of § 672(c), to any beneficiary of a trust.

Accordingly, based on the facts submitted and the representations made we conclude that the transfer of the non-realty assets into the new trusts 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 transfer of the non-realty assets into New Trusts 1, 2, and 3 will not affect the status of Trusts 1, 2, or 3, or New Trusts 1, 2, or 3 for GSTT purposes.

Income Tax

Section 1001 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 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 (other than money) received. Section 1001(c) provides that, except as otherwise provided in Subtitle A, the entire amount of gain or loss determined under § 1001 on the sale or exchange of property shall be recognized.

Section 1.1001-1(a) of the Income Tax Regulations provides that the gain or loss realized from a conversion of property into cash, or from an exchange of property for other property differing materially either in kind or extent, is treated as income or as loss sustained.

For purposes of § 1001, in an exchange of property, each party to the exchange gives up a property interest in return for a new or additional property interest. Such an exchange is a disposition under § 1001(a). See § 1.1001-1.

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

The essential question is whether, upon division of each of Trusts 1, 2, and 3 into a realty trust and a non-realty trust, the beneficiaries will have different beneficial interests in the trusts than they currently have. The beneficiaries of the New Trusts will be the same as the beneficiaries of the existing trusts (Settlor's issue). Additionally, there will not be any changes in the property of each of Trusts 1, 2 and 3 except for the division of the property between the existing trusts and the New Trusts. Neither will there be any change in the rights and duties of the trustees as a result of the proposed transaction. The changes in the trustee appointment and removal provisions will not result in the beneficiaries having any greater or lesser rights in the property of the trusts than they currently have.

Consistent with the Supreme Court's opinion in Cottage Savings, we find that the interests of each of the beneficiaries in Trusts 1, 2, and 3 and the New Trusts after the severance will not differ materially from each of their interests in Trusts 1, 2, 3 prior to the division. Each will remain a potential distributee of all the income and the same assets after the proposed transaction as before, although the beneficiary's assets will be held in two trusts instead of one. Thus the transaction will not result in a material difference in the kind or extent of the legal entitlements of the beneficiaries.

We conclude that, under the proposal for severing the three trusts into six trusts, no gain or loss will be realized under § 1001 by the trusts or the beneficiaries as a result of this transaction. We believe that Trusts 1, 2, and 3 and the New Trusts embody substantially identical legal entitlements and are, consequently, not materially different.

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

Enclosure

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