

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:4-PLR-100681-00

Date:

September 19, 2000

Re:

LEGEND:

- Settlor =
- Spouse =
- Child 1 =
- Child 2 =
- Grandchild 1 =
- Grandchild 2 =
- Grandchild 3 =
- Grandchild 4 =
- Individual A =
- Individual B =
- Date 1 =
- Date 2 =
- Year 1 =
- Year 2 =
- Year 3 =
- Year 4 =
- Year 5 =
- Year 6 =

Dear :

This is in response to your letter of December 23, 1999, in which rulings are requested on the application of the generation-skipping transfer tax and § 1001 of the Internal Revenue Code to the transaction described below.

The facts and representations submitted are as follows:

Settlor created a trust (Intervivos Trust) on Date 1 and transferred to it policies insuring his life. Settlor designated Individual A as the trustee and a trust company as successor trustee.

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Under the terms of Intervivos Trust, beginning at Settlor's death, all of the Trust income is to be paid to Settlor's Spouse, quarterly, for her life. On Spouse's death, the Trust income is to be paid to Settlor's two children, Child 1 and Child 2, in equal shares for their lives. Upon the death of the first child to die, her share of the income is to be paid to her issue, per stirpes. If she has no surviving issue, her share of the income is to be paid to the surviving child of Settlor.

The Intervivos Trust is to terminate upon the death of the survivor of Spouse, Child 1, and Child 2. At termination, the principal is to be distributed to the issue of Child 1 and Child 2, per stirpes. If a child died without issue, that child's share is to be distributed to the issue of the other child, per capita. If there are no living issue of Child 1 or Child 2, the trust principal is to be distributed equally to two nieces of the Settlor. If a niece died survived by issue, her share is to be distributed to her surviving issue, per stirpes. If a niece died without issue, her share is to be distributed to the surviving issue of the other niece. If both nieces have died without surviving issue, the principal is to be distributed to the heirs at law of the last niece to die.

Settlor died on Date 2, and a trust (Testamentary Trust), with Individual A as trustee, was created pursuant to Settlor's will. The provisions of the Testamentary Trust are identical to those of the Intervivos Trust.

In Year 1, Individual A resigned as trustee of both Trusts. The trust company designated by Settlor as successor trustee declined to act as successor trustee of the Intervivos Trust. Pursuant to decrees issued by the local probate court, Spouse, Child 1 and Child 2 were appointed trustees of both Trusts and were required by the court to post joint corporate surety bonds. The court also appointed a corporate fiduciary as depositary of the assets of both Trusts and ordered that none of the assets were to be sold, exchanged or reinvested without prior court approval. In its decree relating to the Intervivos Trust, the court restated the trust provisions. In doing so, the court omitted the name of one of Settlor's nieces as a contingent remainder beneficiary of that Trust.

In Year 2, Spouse died. Child 1 and Child 2 continued to serve as trustees of both Trusts, and the income of both Trusts was distributed to them in equal shares.

In Year 3, Child 1 and Child 2, as trustees, petitioned the local probate court for removal of the requirement of court approval for the sale, exchange, or reinvestment of the Trusts' assets. The court granted the petition.

In Year 4, Child 1 and Child 2, as trustees, petitioned the local probate court for termination of the fiduciary bond. The court granted the petition.

In Year 5, Child 2 died. Since her death, her share of income from both Trusts has been distributed to her two children, Grandchild 1 and Grandchild 2.

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In Year 6, Child 1 resigned as trustee of both Trusts. The local probate court appointed Individual B, and Grandchild 3 and Grandchild 4, the children of Child 1, as trustees of both Trusts.

At the present time, Child 1 is receiving one-half of the income of both Trusts. Child 1 has two children (Grandchild 3 and Grandchild 4), four grandchildren, and four great-grandchildren. The two children of Child 2 (Grandchild 1 and Grandchild 2) are receiving one-half of the income of both Trusts, one-quarter each. Child 2 was also survived by two grandchildren.

The trustees of both Trusts propose to combine the two Trusts into one trust and to divide the combined trust into four separate trusts: the Grandchild 1 Trust, the Grandchild 2 Trust, the Grandchild 3 Trust, and the Grandchild 4 Trust. Each of the four trusts will be funded, to the extent possible, with a pro rata share of the assets of the combined trust. Individual B will be the trustee of the Grandchild 1 Trust and the Grandchild 2 Trust. Grandchild 3 will be the trustee of the Grandchild 3 Trust, and Grandchild 4 will be the trustee of the Grandchild 4 Trust.

Each of the four new trusts will continue for the life of Child 1. Child 1 will continue to receive the income from the trusts for the benefit of her children, Grandchild 3 and Grandchild 4. Grandchild 1 and Grandchild 2 will receive the income from their respective trusts. If either Grandchild 1 or Grandchild 2 predeceases Child 1, the income of the deceased grandchild's trust will be paid to the deceased grandchild's issue, per stirpes. If the deceased grandchild is not survived by issue, the income will be paid to the issue of Child 2, per stirpes. If there are no living issue of Child 2, the income will be paid to Child 1.

Each of the four new trusts will terminate at the death of Child 1, and the principal of each trust will be distributed to the grandchild for whom the trust is named. If a grandchild is not living at the time his or her trust terminates, the principal of the deceased grandchild's trust will be distributed to the deceased grandchild's issue, per stirpes. If either Grandchild 1 or Grandchild 2 predeceases Child 1 (i.e., dies before the termination of his or her trust), and is not survived by issue, the principal of his or her trust will be distributed to the living issue of Child 2, per stirpes. If there are no living issue of Child 2, the principal will be distributed to the living issue of Child 1, per capita. If either Grandchild 3 or Grandchild 4 predeceases Child 1 (i.e., dies before the termination of her trust), and is not survived by issue, the principal of her trust will be distributed to the living issue of Child 1, per stirpes. If there are no living issue of Child 1, the principal will be distributed to the living issue of Child 2, per capita.

If there are no surviving issue of Child 1 or Child 2 at the time the four new trusts terminate, the principal of the trusts will be distributed to the nieces of the Settlor in accordance with the terms of the original Intervivos Trust and Testamentary Trust, as modified by the decree of the local probate court issued in Year 1 which omitted one of

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Settlor's nieces as a beneficiary of the Intervivos Trust.

In Year 6, the trustees of the Intervivos Trust and the Testamentary Trust petitioned the local probate court for orders with respect to the proposed transactions. Specifically, orders were requested:

- 1) authorizing the combination of the Trusts into a combined trust;
- 2) authorizing the division of the combined trust into the four new trusts, each funded, to the extent possible, with a one-fourth pro rata share of each and every asset of the combined trust;
- 3) accepting the resignation of the trustees of the Intervivos Trust and the Testamentary Trust and appointing the trustees for each of the four new trusts;
- 4) terminating the depositary requirement imposed by the court in Year 1; and
- 5) confirming that the new trusts are not subject to the continuing supervision of the court under state law.

In Year 6, the court issued an order acquiescing to the petition contingent upon the trustees' obtaining a favorable ruling from the Service.

The following rulings have been requested:

1. The pro rata distribution of assets from the Intervivos Trust and the Testamentary Trust to the combined trust and from the combined trust to the four new trusts does not give rise to a realization event under § 1001.
2. The four new trusts are exempt from generation-skipping transfer tax and no additions have been made to the new trusts.

Ruling 1

Section 61(a)(3) provides that gross income includes gains derived from dealings in property. 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 provided in such section for determining loss over the amount realized.

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

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In Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), the Supreme Court addressed the issue of whether there is a sale or exchange resulting in the realization of gain or loss under § 1001. Under the facts of that case, 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 institutions. The 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." Id. at 560-561. In defining what constitutes a "material difference" for purposes of § 1001(a), the Court stated 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 564-565. 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 the loans.

In the present case, the governing instruments of the Intervivos Trust and the Testamentary Trust do not give the trustees authority to partition the Trusts' assets or to make any distribution of principal until the death of the survivor of Spouse, Child 1 and Child 2. Therefore, the proposed transaction is not a mere distribution pursuant to the Trusts' terms and constitutes an exchange by the Trusts' beneficiaries of their interests in the Trusts for their interests in the new trusts.

The assets of the Intervivos Trust and the Testamentary Trust are to be combined and distributed pro rata to trusts for each of the four remainder beneficiaries. It is consistent with the Supreme Court's opinion in Cottage Savings to conclude that the interests of the beneficiaries in the Intervivos Trust and the Testamentary Trust will not differ materially from their interests in the new trusts. Both before and after the proposed transaction, each beneficiary is entitled to substantially the same income and/or remainder interests in the Trusts' assets. The proposed transaction is consistent with the dispositive provisions of the Intervivos Trust and the Testamentary Trust. Under the proposed transaction, if any of the Settlor's grandchildren predecease Child 1 without issue, upon Child 1's death, the assets of the trust for that predeceased grandchild are to be distributed to the surviving remainder beneficiaries. Accordingly, based on the facts submitted and representations made, we conclude that the interests to be exchanged are not materially different, and the proposed exchanges of property do not give rise to a realization event under § 1001(a).

Ruling 2

Section 2601 imposes a tax on every generation-skipping transfer (GST). Section 2611 defines a generation-skipping transfer as a taxable termination, a taxable distribution, or a direct skip.

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Section 1433(b)(2)(A) of the Tax Reform Act of 1986 (the Act), 1986-3 (Vol. 1) C.B. 1, and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax (GSTT) Regulations provide that the GSTT shall not apply to any GST under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added).

Section 26.2601-1(b)(1)(iv) provides that if an addition is made after September 25, 1985, to an irrevocable trust which is excluded from the GSTT by section 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 GSTT.

In the present case, the Intervivos Trust and the Testamentary Trust were irrevocable prior to September 25, 1985, and it is represented that no additions have been made to either trust after September 25, 1985.

The partitioning of a trust that does not otherwise change the quality, value, or timing of any of the powers, beneficial interests, rights, or expectancies originally provided for under the terms of the trust will not result in the loss of the trust's exempt GST status under section 1433(b)(2)(A) of the Act or § 26.2601-1(b)(1) of the regulations.

In the present case, combining the Intervivos Trust and the Testamentary Trust, which have identical terms and beneficiaries, and partitioning the combined trust into the four new trusts will not change the quality, value, or timing of the powers, beneficial interests, rights, or expectancies originally provided for under the terms of the original Trusts. Therefore, based on the facts submitted and representations made, we conclude that the pro rata distribution of assets from the Intervivos Trust and the Testamentary Trust to the combined trust and from the combined trust to the four new trusts will not cause any of the trusts to lose their exempt status for generation-skipping transfer tax purposes and will not constitute an addition to any of the trusts.

In addition, the resignation of the trustees and appointment of new trustees, the termination of the depository requirement, and the termination of court supervision are changes which are administrative in nature and do not affect the quality, value, or timing of the powers, beneficial interests, rights, or expectancies originally provided for under the terms of the Intervivos Trust or the Testamentary Trust. Therefore, these changes will not cause any of the trusts to lose their exempt status for generation-skipping transfer tax purposes.

Except as we have specifically ruled herein, we express no opinion on the federal tax consequences of the proposed transaction under the cited provisions or under any other provision of the Code. In particular, we express no opinion with respect to the omission of one of Settlor's nieces as a contingent remainder beneficiary

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of the Intervivos Trust in the decree of the local probate court issued in Year 1.

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

Sincerely yours,

Associate Chief Counsel
(Passthroughs and Special Industries)

By _____
Katherine A. Mellody
Senior Technician Reviewer
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Enclosure:
Copy for § 6110 purposes