



Grandchild B's Trust B =

Grandchild C's Trust B =

Corporate Trustee =

Individual Trustee A =

Individual Trustee B =

Bank =

Fund =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

State =

Statute =

Court =

Dear \_\_\_\_\_ :

This responds to a letter from your authorized representative dated October 20, 2003, and prior correspondence, requesting rulings regarding the federal income and generation-skipping transfer (GST) tax consequences of a proposed severance of certain trusts.

### Facts

The facts submitted and representations made are as follows:

Grandparent A died on Date 1, survived by his spouse, Grandparent B, who subsequently died on Date 2. Grandparent A and Grandparent B had two children, Child A and Child B. Child A had three children, Grandchild A, Grandchild B, and Grandchild C. Child A died on Date 3. Child B never married and never had children. Date 1, Date 2 and Date 3 are prior to September 25, 1985.

Grandparent A's will provided for the creation of Trust A. Under Article III, paragraph (a), Trust A was to be held for the benefit of Grandparent B during her life. Pursuant to Article III, paragraph (b), on Grandparent B's death Trust A was divided into equal shares for the benefit of each child of Child A then living. Therefore, following the death of Grandparent B on Date 2, Trust A was divided into Grandchild A's Trust A, Grandchild B's Trust A, and Grandchild C's Trust A. Each share has been administered as a separate trust.

Under Article III, paragraph (d), until the complete distribution of a grandchild's trust, or until the grandchild's prior death, so much of the net income is to be distributed to that grandchild as the trustees in their absolute discretion deem reasonably necessary for the grandchild's comfortable support, education, and welfare. The remaining income may be distributed to any one or more of Grandparent A's descendants (except Child A and Child B) and their spouses, as the trustees in their absolute discretion deem advisable. Any remaining income is to be added to the principal of the share.

Under Article III, paragraph (e) of Trust A, the trustees may distribute such principal of a grandchild's trust only to that grandchild, in their absolute discretion, as the trustees deem advisable. Each grandchild has a limited testamentary power of appointment under paragraph (e) to direct distribution of that grandchild's trust share among the grandchild's lawful descendants, in such proportions and subject to such trusts and conditions as such grandchild directs. In default thereof, upon a grandchild's death, the trustee is directed to distribute the grandchild's share, per stirpes to Grandparent A's lawful descendants, with a special provision for the widow of either Grandchild A and Grandchild B who should die without leaving a lawful descendant who survives such grandchild.

Paragraph (h) of Article III contains a provision mandating the termination and distribution of each grandchild's trust no later than 21 years after the death of the last survivor of a listed class of individuals living at the death of Grandparent A.

Paragraph (n) of Article III authorizes the trustee, inter alia, to determine whether and in what proportions any receipts or disbursements shall be credited, charged to or apportioned between income and principal.

Grandparent B created Trust B, an irrevocable trust, on Date 4. Date 4 is prior to September 25, 1985. Under Trust B, a separate trust was created for each grandchild of Grandparent B: Grandchild A's Trust B, Grandchild B's Trust B, and Grandchild C's Trust B.

Pursuant to paragraph (c) of Article I of Trust B, until the death of the grandchild, the trustee may distribute so much of the net income to that grandchild as the trustee in its absolute discretion deems advisable for the grandchild's comfortable support, education, welfare and happiness. The trustee may either accumulate the remaining net income or distribute so much of it to any one or more of Grandparent B's lawful descendants and their spouses in such proportions as the trustee deems advisable. Paragraph (c) also provides that the trustee may only distribute principal to the grandchild of such share. Under paragraph (d), the trustee may add undistributed net income to principal, or may retain such income in an "accumulated income account" for possible future distribution to beneficiaries from time to time eligible to receive current distributions of net income.

Pursuant to the terms of Trust B, each grandchild has a limited testamentary power of appointment under paragraph (e) of Article I to direct distribution of such grandchild's trust among Grandparent B's lawful descendants, in such proportions and subject to such trusts and conditions as such grandchild directs. In default of appointment, upon the grandchild's death, the trustee is directed to distribute the trust per stirpes to the primary beneficiary's lawful descendants, or if none, per stirpes to Grandchild B's lawful descendants, with a special provision for the widow of either of Grandchild A and Grandchild B who should die without leaving a lawful descendant who survives such grandchild; provided, however, that if the trustee deems any descendants of Grandparent B to be incapable of using to good advantage the share otherwise to be so received, the trustee may allocate such trust among any of the other descendants of Grandparent B in such proportions as the trustee deems proper.

Paragraph (g) of Article I contains a provision mandating the termination and distributions of each trust under Trust B no later than 21 years after the death of the last survivor of a listed class of individuals living at the date of execution of the agreement creating Trust B.

Paragraph (l) of Article I provides that the trustee shall have the power inter alia, to determine whether and in what proportions any receipts or disbursements shall be credited, charged or apportioned between income and principal.

The trustees of Trust A are Bank and two individuals. Bank is the sole trustee of Trust B. A significant portion of the assets of each of the current trusts consists of interests in common trust funds (CTFs), as defined in § 584, maintained by Bank.

On Date 5, the Internal Revenue Service issued private letter rulings (the "Prior Rulings") concluding that the entry by Court of an order authorizing the trustee to allocate capital gain receipts to income and charge certain income expenses to corpus, and the trustees' exercise of discretion in accordance with that court order, will not adversely affect the status of Grandchild A's Trust A, Grandchild A's Trust B, Grandchild B's Trust A, Grandchild B's Trust B, Grandchild C's Trust A, and Grandchild C's Trust B as exempt from GST tax.

Each grandchild has three children, the great-grandchildren of Grandparent A and Grandparent B. The parties propose to divide each grandchild's separate trust under Trust A and Trust B into three equal separate new trusts, collectively known as the "New Trusts." The parties propose to name each of the nine New Trusts for one of the nine great-grandchildren. Specifically, the trusts will be severed as follows:

Grandchild A's Trust A will be divided into three equal trusts, one each for Great-grandchild A, Great-grandchild B, and Great-grandchild C. Grandchild A's Trust B will also be divided into three equal trusts, one each for Great-grandchild A, Great-grandchild B, and Great-grandchild C.

Grandchild B's Trust A will be divided into three equal trusts, one each for Great-grandchild D, Great-grandchild E, and Great-grandchild F. Grandchild B's Trust B will also be divided into three equal trusts, one each for Great-grandchild D, Great-grandchild E, and Great-grandchild F.

Grandchild C's Trust A will be divided into three equal trusts, one each for Great-grandchild G, Great-grandchild H, and Great-grandchild I. Grandchild C's Trust B will also be divided into three equal trusts, one each for Great-grandchild G, Great-grandchild H, and Great-grandchild I.

All of the trust provisions of each New Trust will remain identical to the terms of the original trust from which it was derived prior to the severance. The primary beneficiary of each New Trust will still be the grandchild who was the original primary beneficiary prior to severance, and who will also be the only eligible recipient of principal during that grandchild's life. The trustees' discretionary powers with respect to undistributed income will be unchanged (including the permissible beneficiaries). The trust term and the provisions regarding disposition of trust assets at termination will also be the same.

The trustees represent that each New Trust will be separately managed and administered. The assets of each New Trust will be invested separately and titled solely in the name of that trust. The New Trusts will each file separate income tax returns, separately track state law accounting income, and keep separate trust records. The trustees represent that the principal purposes of severing the trusts are to accommodate the differing income distribution needs and differing investment objectives of the descendants of the grandchildren, and that there is no tax avoidance purpose to the proposed severance.

The trustee, subject to asset availability and fiduciary duties, intends to continue to make the discretionary income distributions only to the grandchild and to the great-grandchild for whom the New Trust is named and that great-grandchild's family. You represent that there have been no additions to Trust A or Trust B since September 25, 1985. The trusts are governed by the laws of State. You also represent that Statute of State law gives the trustees the power to sever the trusts as proposed.

## **RULINGS REQUESTED**

1. The exercise of the trustee's power to sever each trust on a fractional basis into the New Trusts under State law will not adversely affect the trusts' status as exempt from the GST tax under chapter 13, and each New Trust created as a result of the severance will remain exempt from the GST tax.

2. The exercise of the trustee's power to sever each trust on a fractional basis into the New Trusts in accordance with State law will not cause the original trusts, the

New Trusts, or their beneficiaries to realize gain or loss from the sale or other disposition of property under § 1001.

3. The exercise of the trustee's power to sever each trust and transfer the trusts' units of participation in Fund, on a fractional, in-kind basis into the New Trusts in accordance with State law will not cause the current trusts, the New Trusts, or their beneficiaries to realize gain or loss from the sale or exchange of a participating interest in a common trust fund under § 584 as a result of such severance or transfer.

4. Each of the New Trusts will be treated as a separate trust for federal income tax purposes.

5. The holding of the Prior Rulings will apply to each of the New Trusts, and the exercise of fiduciary discretion by the trustee of a New Trust to credit realized capital gains of that trust to income and to charge income expenses of that trust to principal (in a manner consistent with the Prior Rulings) will not adversely affect that trust's status as exempt from the GST tax under chapter 13.

#### Ruling Request No. 1 – GST Tax

Section 2601 imposes a tax on every generation-skipping transfer. Under § 1433(a) of the Tax Reform Act of 1986 (Act), the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, 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.

Under § 2602, the amount of tax imposed under § 2601 is determined by multiplying the taxable amount by the applicable rate. The taxable amount of a taxable distribution is the amount received by the transferee (§ 2621), of a taxable termination is the amount of property with respect to which there was a termination (§ 2622), and of a direct skip is the amount received by the transferee (§ 2623).

Under § 2641, the term "applicable rate" means the product of the maximum federal estate tax rate in the year that the generation-skipping transfer occurs and the inclusion ratio.

Under § 2642(a)(1), the inclusion ratio with respect to any property transferred in a generation-skipping transfer is 1 minus the applicable fraction. Under § 2642(a)(2), in general, the numerator of the applicable fraction is the GST exemption amount

allocated to the property transferred and the denominator is the value of the property transferred.

Under § 2631, every individual is allowed a GST exemption amount which may be allocated by the individual or the individual's executor to any property with respect to which the individual is the transferor.

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 GST tax will not cause the trust to lose its exempt status.

Section 26.2601-1(b)(4)(i)(D) provides that a modification 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.

Section 26.2601-1(b)(4)(i)(E), Example 5, illustrates a situation where a trust that is otherwise exempt from the GST tax authorizes the trustee to distribute income and principal, at the trustee's discretion, for the benefit of A and B and their respective issue. On the death of the last to die of A and B, the corpus is to be distributed to the issue of A and B, per stirpes. Pursuant to a court order, the trust is divided equally into two trusts, one for the benefit of A and A's issue, and one for the benefit of B and B's issue. The example concludes that, under the facts presented, the division of the trust into two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the division, and the division does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Accordingly, the two partitioned trusts will not be subject to the provisions of chapter 13.

In the present case, the parties propose to divide each grandchild's separate trust created under Trust A and Trust B into three equal separate new trusts, with one trust named for each great-grandchild. All of the trust provisions of each New Trust will remain identical to the terms of the original trust from which it was derived prior to the severance. The primary beneficiary of each New Trust will still be a grandchild for whom the original trust was established, and that grandchild will also be the only eligible recipient of principal during that grandchild's life. The trustees' discretionary powers with respect to undistributed income will be unchanged (including the permissible beneficiaries). The trust term and the provisions regarding disposition of trust assets at termination will also be the same. Therefore, the proposed division will not shift a

beneficial interest in the trusts to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the division. In addition, the division does not extend the time for vesting of any beneficial interest beyond the period provided for in the original trusts.

Accordingly, based on the facts submitted and the representations made, we conclude that the exercise of the trustee's power to sever the trusts on a fractional basis into the New Trusts under State law will not adversely affect the trusts' status as exempt from the GST tax under chapter 13, and each New Trust created as a result of the severance will remain exempt from the GST tax.

#### Ruling Request No. 2 –Gain or Loss

Section 61(a)(3) provides that gross income includes gains derived from dealings in property and, under § 61(a)(15), from an interest in trust.

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) states 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. Under 1001(c), 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.

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 of the transaction. Thus, neither gain nor loss is realized on a partition. See Rev. Rul. 56-437, 1956-2 C.B. 507.

Cottage Savings Assoc. v. Commissioner, 499 U.S. 554 (1991), concerns the issue of when a sale or exchange has taken place that results in a realization of gain or loss under § 1001. In Cottage Savings, a financial institution exchanged its interest 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.

In Cottage Savings, 499 U.S. at 560-61, 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.” 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. 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.

Under State law, the trustee has the power to “sever any trust estate on a fractional basis into 2 or more separate trusts for any reason. . . . A separate account or trust created by severance or segregation shall be treated as a separate trust for all purposes from and after the date on which the severance or segregation is effective, and shall be held on terms and conditions that are substantially equivalent to the terms of the trust from which it was severed or segregated so that the aggregate interests of each beneficiary in the severed trusts are substantially equivalent to the beneficiary’s interests in the trust before severance. . . .” See Statute.

It is consistent with the Supreme Court’s opinion in Cottage Savings to find that the interests of the beneficiaries of the New Trusts will not differ materially from their interests in the original grandchild trusts. In the proposed transaction, the original trusts will be severed in accordance with State law on a pro rata basis. Except for the changes described above, all other provisions of the New Trusts will remain unchanged. Accordingly, the proposed transaction will not result in a material difference in kind or extent of the legal entitlements enjoyed by the beneficiaries, and no gain or loss is recognized on the partition of the trusts for purposes of § 1001(a).

### Ruling Request No. 3 – Common Trust Fund

Section 584(a)(1)(A) provides that for purposes of subtitle A, the term “common trust fund” (CTF) means a fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian.

Section 584(e) provides that no gain or loss shall be realized by the CTF by the admission or withdrawal of a participant. The admission of a participant shall be treated with respect to the participant as the purchase of, or an exchange for, the participating interest. The withdrawal of any participating interest by a participant shall be treated as a sale or exchange of such interest by the participant.

Rev. Rul. 60-256, 1960-2 C.B. 193, holds that a transfer of units of participation in a CTF from one trust, of which the taxpayer is the sole beneficiary, to another trust, of which the taxpayer is also the sole beneficiary, does not constitute a “withdrawal” of a

participating interest within the meaning of § 584(e), provided that no funds change hands, there is no surrender of indicia of ownership, nothing is received by the taxpayer, and the trustee of the two trusts is the same. Under such circumstances, the basis of the participating units in the hands of the transferee trust is the same as it was in the hands of the transferor trust on the date of transfer.

Based solely on the facts and representations submitted, we conclude that the transfer of the CTF participating interests from the current trusts to the New Trusts does not constitute a “withdrawal.” Therefore, no gain or loss will be realized by the CTF, the current trusts, the New Trusts, or any trust beneficiary under § 584(e).

#### Ruling Request No. 4 – Section 643

Section 643(f) provides that, under regulations 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.

The primary purposes of establishing the New Trusts are represented as being to accommodate the differing income distribution needs and investment objectives of the descendants of the grandchildren. It is further represented that there is no tax avoidance purpose in the establishment of the New Trusts within the meaning of § 643(f)(2). Determining whether avoidance of income tax is a primary purpose of the establishment of the New Trusts is a question of fact, the determination of which must be deferred until the federal income tax returns of the parties involved have been examined by the office having examination jurisdiction over those income tax returns.

Therefore, provided that the New Trusts are separately managed and administered and it is determined that tax avoidance is not a primary purpose of the establishment of the New Trusts, each of the New Trusts will be treated as a separate trust for federal income tax purposes.

#### Ruling Request No. 5 – Prior Rulings

Section 6110(k)(3) provides that a taxpayer may not rely on a private letter ruling issued to another taxpayer. See also § 11.03 of Rev. Proc. 2004-1, 2004-1 C.B. 1, 45.

In this case, after the severance, all trust provisions will remain identical to the terms of the original trust from which it was derived prior to the severance, including Paragraph (n) of Article III of Trust A and Paragraph (l) of Article I of Trust B, the provisions subject to the court order considered in the Prior Rulings. Accordingly, based on the facts and representations, we conclude that the holdings in the Prior Rulings will apply to each of the New Trusts. Therefore, the exercise of fiduciary discretion by the trustee of a New Trust to credit realized capital gains of that trust to income and to charge income expenses of that trust to principal in a manner consistent

with the Prior Rulings and the Court orders upon which those rulings were based, will not adversely affect that trust's status as exempt from the GST tax under chapter 13.

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.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely yours,

By \_\_\_\_\_  
George L. Masnik  
Branch Chief, Branch 4  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosure  
Copy for section 6110 purposes

cc: