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

This is in response to a letter dated August 12, 2005, and other correspondence, requesting rulings regarding the income and generation-skipping transfer (GST) tax consequences of proposed modifications and the division of Son's Trust.

### Facts

The facts submitted and representations made are as follows. Before her death, Decedent established a revocable trust (Trust). Trust became irrevocable at Decedent's death on Date 1, prior to September 25, 1985.

Under Article 2, at Decedent's death, Trust was to be divided into separate equal trusts, one trust for each of Decedent's then living children and one trust for the then living issue of any then deceased child of Decedent. Article 2 provides that the income of each separate trust established for a child of Decedent will be paid, at least quarterly, to the child for life and at the child's death, to "his issue living from time to time by right of representation." However, notwithstanding that provision, each child of Decedent has a testamentary power to appoint the income of his trust or the income of the trust held for his issue to that child's widow, to be paid to her until the earlier of her death or the termination of the trusts created under Trust.

Further, the second paragraph of Article 3 provides:

Notwithstanding the above provisions for payment of income to or for a child or the issue of a child, the Trustees, instead of paying income to a particular person, may in their absolute discretion pay all or any part of such income to or for the benefit of any one or more of the issue of such person, or they may hold such income or any part thereof for future distribution to such person or one or more of the issue of such person, or may add such income to the principal of the trust.

The first paragraph of Article 3 provides that all trusts created under Trust will terminate 20 years after the death of the last surviving child of Decedent (the Termination Date). The remaining principal of each trust will be paid outright, by right of representation, to the then living issue of the child of Decedent for whom the trust was

established; or if none, by right of representation to Decedent's then living issue. If a child of Decedent and that child's issue all die before the Termination Date, the trust for that deceased child will terminate and the remaining principal will be distributed by right of representation to Decedent's then living issue.

Article 7 provides:

Whenever the Trustees under this instrument shall have occasion to set apart or to pay over, transfer or convey unto any person any share of the principal of the trust fund, they shall have power to select for that purpose and set apart, transfer or convey, as the case may require, such property, real or personal, as they may judge fair and proper upon and at their own valuation and without any other appraisal, and such valuation shall be conclusive upon all parties interested whether then in being or not.

Article 8 of Trust provides that, upon the death, resignation, removal, or inability of any trustee to serve, a successor trustee may be appointed by the surviving or other trustees; or if none, by a majority of the adult income beneficiaries, having legal capacity, of the trust for which the trustee is being appointed.

Decedent was survived by three children, one of whom was Son. In accordance with Article 2 of Trust, upon Decedent's death on Date 1, Trust was divided into three separate equal trusts, one for the primary benefit of each of Decedent's three children. Son's Trust was established for the benefit of Son. All three trusts are still in existence. However, two of Decedent's children have died, including Son who died on Date 2. Thus, one trust is currently being held for the primary benefit of Decedent's last surviving child, who has adult children. A second trust is currently being held for the primary benefit of the adult children of a deceased child of Decedent. Son's Trust is currently being held for the primary benefit of Son's adult children, Grandchild 1, Grandchild 2, Grandchild 3, Grandchild 4, and Grandchild 5.

Individual 1, Individual 2, and Individual 3 (the Trustees) currently serve as trustees of the three trusts created under Trust, including Son's Trust. Individuals 1, 2, and 3 are not related to any of the beneficiaries of the three trusts. The Trustees have not made any income distributions to Grandchildren 1, 2, 3, 4, and 5.

On Date 3 the Trustees filed a complaint with Court requesting that Court issue an order, contingent upon the receipt of a favorable ruling from the Internal Revenue Service, reforming Son's Trust to authorize the trustees to divide Son's Trust into separate equal trusts for the benefit of Son's children and their issue. To implement this reformation, the complaint requests the Court to issue an order, approving the modification of Article 2, a modification of the first paragraph of Article 3, and a modification of Article 8, as these provisions apply to Son's Trust.

Article 2 will be modified as to Son's Trust by adding two new sentences in addition to the current provisions of Article 2. These new sentences provide as follows as to "the share of the Trust for [Son]":

Notwithstanding the above provision [for division at Decedent's death of Trust into separate equal trusts, one trust for each of Decedent's then living children and one trust for the then living issue of any then deceased child of Decedent], the Trustees, at any time and from time to time, may further divide any trust then being held for the issue of a deceased child of the [Decedent] (regardless of whether such child predeceased the [Decedent]) into equal trusts, one for each then living child of the deceased child of the [Decedent] and one for each child of the deceased child of the [Decedent] who has died leaving issue then living. Each trust so established shall be named for the person for whom it was set apart and the income thereof shall be paid to or for the benefit of the issue living from time to time of such deceased child of the [Decedent], by right of representation.

The first paragraph of Article 3 will be modified as to Son's Trust by replacing the first sentence with four new sentences. The new language provides for termination of all trusts created under Son's Trust (i.e. the trusts named for Grandchildren 1, 2, 3, 4, and 5) on the Termination Date specified in Trust (20 years after the death of the last surviving child of Decedent). The new language provides that the aggregate accumulated income from all trusts created under Son's Trust will be distributed as follows:

Immediately prior to the Termination Date, the Trustees shall pay over the accumulated income of each trust named for a child of a deceased child of [Decedent] to the then living issue of such deceased child of [Decedent], such issue to take the accumulated income by right of representation; or in default of such issue, then the Trustees shall pay over the accumulated income to the then living issue of the [Decedent] by right of representation.

The new language further provides for distribution of principal at the Termination Date as to the Son's Trust as follows:

The Trustees shall pay over the remaining principal of each trust named for a child of a deceased child of the [Decedent] free of all trusts to the person for whom the trust is named, or if he or she is not then living, to his or her then living issue, such issue to take the principal by right of representation, or in default of such issue, then the Trustees shall pay over the principal to the issue of the nearest lineal ancestor of the person for whom the trust is named by right of

representation, or if none, to the then living issue of the [Decedent] by right of representation.

The second paragraph of Article 3, authorizing the Trustees to withhold, etc., distributions of income will remain in effect.

Article 8 will be modified by adding a sentence to the original provisions of Article 8, as to Son's Trust, providing that a trustee of any trust created pursuant to a division of Son's Trust cannot be related or subordinate, within the meaning of § 672(c) to any of the beneficiaries of any such trusts.

The complaint further requests the appointment of a guardian ad litem to represent any minor, unborn, or unascertained beneficiaries of Son's Trust.

After the court order is issued, pursuant to the terms of Trust, as reformed, the Trustees propose to divide Son's Trust into five separate equal trusts (the Subtrusts). Each Subtrust will be named for one grandchild, among Grandchildren 1, 2, 3, 4, and 5. The Trustees will distribute the assets of Son's Trust to these five equal trusts on a non-pro rata basis.

It is represented that no additions have been made since September 25, 1985, to the three trusts established under Trust, including Son's Trust.

The taxpayers have requested the following rulings:

1. The proposed division of Son's Trust into Subtrusts under the requested judicial reformation of Son's Trust will not cause Son's Trust to be subject to GST tax under chapter 13 of the Code.
2. The proposed division of Son's Trust into Subtrusts under the requested judicial reformation of Son's Trust will not result in a transfer by any of the beneficiaries that is subject to gift tax under § 2501.
3. The proposed division of Son's Trust into Subtrusts under the requested judicial reformation of Son's Trust and the proposed non-pro rata funding of each respective Subtrust will not be treated as a realization event with respect to any of the assets of Son's Trust within the meaning of § 1001 of the Internal Revenue Code.

Ruling Request #1:

Section 2601 imposes a tax on each generation-skipping transfer made by a transferor 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)(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 generation-skipping transfer tax will not cause the trust to lose its exempt status. The regulation provides that the rules contained in the paragraph are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. The rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001.

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. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust.

Example 5, contained in § 26.2601-1(b)(4)(i)(E), considers a situation where, in 1980, Grantor established an irrevocable trust for the benefit of his two children, A and B, and their issue. Under the terms of the trust, the trustee has the discretion to distribute income and principal to A, B, and their issue in such amounts as the trustee deems appropriate. On the death of the last to die of A and B, the trust principal is to be distributed to the living issue of A and B, per stirpes. In 2002, the appropriate local court approved the division of the trust into two equal trusts, one for the benefit of A and A's issue and one for the benefit of B and B's issue. The trust for A and A's issue provides that the trustee has the discretion to distribute trust income and principal to A and A's issue in such amounts as the trustee deems appropriate. On A's death, the

trust principal is to be distributed equally to A's issue, per stirpes. If A dies with no living descendants, the principal will be added to the trust for B and B's issue. The trust for B and B's issue is identical (except for the beneficiaries), and terminates at B's death at which time the trust principal is to be distributed equally to B's issue, per stirpes. If B dies with no living descendants, principal will be added to the trust for A and A's issue. 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. In addition, 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. Therefore, the two partitioned trusts resulting from the division will not be subject to the provisions of chapter 13.

In the present case, Trust and Son's Trust, became irrevocable before September 25, 1985. Thus, Son's Trust is not subject to GST tax. It is represented that no additions were made to Son's Trust after September 25, 1985.

Under the original terms of Trust, Grandchildren 1, 2, 3, 4, and 5 are entitled, under Article 2, to receive equal shares of the total income of Son's Trust, at least quarterly. However, under the second paragraph of Article 3, the trustees have absolute discretion to withhold any part of a particular Grandchild's share of that income or to pay, when a distribution comes due or in the future, any part of that share to the particular Grandchild or to any of that Grandchild's issue. In addition, the trustees can accumulate the income and add it to Trust principal. At the Termination Date, Son's Trust will terminate and the remaining assets of Son's Trust, including all accumulated income, will be distributed outright, by right of representation, to Son's then living issue; or if none, by right of representation to Decedent's then living issue.

Under the proposed reformation and division, Son's trust will be divided into 5 equal Subtrusts, each named, respectively, for one of Grandchildren 1, 2, 3, 4, and 5. Under the terms of Article 2, as reformed, each Grandchild will be entitled to receive an equal share of the income of all of the Subtrusts. However, the second paragraph of Article 3 will remain in effect. Thus, the trustees will continue to have the absolute discretion to withhold income from a particular Grandchild, or pay the income from the Grandchild's Subtrust to that Grandchild's issue; or accumulate the income of the Subtrust and add it to the principal of the Subtrust. Under the first paragraph of Article 3, as reformed, at the Termination Date, the aggregate accumulated income of all 5 Subtrusts will be distributed outright, by right of representation, to the then living issue of Son; or if none, to Decedent's then living issue by right of representation. Further under the first paragraph of Article 3, as reformed, the five Subtrusts will terminate at the same time as provided under Trust, on the Termination Date. At that time, the remaining assets of each Subtrust will be distributed outright to the Grandchild for whom the Subtrust is named or to that Grandchild's then living issue, by right of

representation; or if none, to the then living issue of Son by right of representation; or if none, to Decedent's then living issue by right of representation.

The proposed judicial reformation Of Son's Trust and the proposed division of Son's Trust into the five Subtrusts, as described above, is substantially similar to the situation described in Example 5 of § 26.2601-1(b)(4)(i)(E). The proposed reformation and division will not result in a shift of any beneficial interest in the trust assets to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the proposed division. The Subtrusts must terminate on the same date that Son's Trust was required to terminate. Thus, the proposed division will not extend the time for vesting of any beneficial interest in the Subtrusts beyond the period provided for in Son's Trust. The modification of Article 8 regarding permissible trustees is administrative in nature.

Accordingly, based on the facts submitted and the representations made and assuming Court issues the requested order reforming Son's Trust, and that the proposed division of Son's Trust is carried out, and is effective, under State law, the proposed reformation and division of Son's Trust into Subtrusts, as described above, will not cause Son's Trust to be subject to GST tax under chapter 13 of the Code.

#### Ruling Request #2:

Section 2501 imposes a tax on the transfer of property by gift by an individual. Section 2511 provides that the tax imposed by § 2501 applies 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.

Section 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift. Section 2512(b) provides that where property is transferred for less than an adequate consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration is deemed a gift.

As discussed above, under the requested judicial reformation and proposed division of Son's Trust, each beneficiary of Son's Trust will have an interest in the income and principal of the Subtrusts identical to that beneficiary's interest in the income and principal of Son's Trust under the original terms of Trust.

Accordingly, based on the facts submitted and the representations made and assuming Court issues the requested order and that the proposed division of Son's Trust is carried out, and is effective, under State law, we conclude that the proposed division of Son's Trust into Subtrusts under the requested judicial reformation of Son's

Trust will not result in a transfer by any of the beneficiaries that is subject to federal gift tax under § 2501.

### Ruling Request #3

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 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 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 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.

In Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), 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 issue presented was whether the exchange of interests in the residential mortgage loans resulted in the realization of gain or loss under § 1001.

The Court concluded that § 1.1001-1 constitutes a reasonable interpretation of § 1001(a). Further, the Court stated that an exchange of property gives rise to a realization event under § 1001(a) if the properties exchanged are "materially different." In determining what constitutes a "material difference" for purposes of § 1001(a), the Court concluded that properties are "different" in the sense that is "material" to the Internal Revenue 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.

In the present case, pursuant to the proposed judicial reformation, Son's Trust, which was established pursuant to the terms of Trust, will be divided into equal trusts (Subtrusts) on a non pro-rata basis. Under Trust, the trustees have authority to make non pro-rata distributions of principal. Under the proposed judicial reformation, the provisions of Trust will remain substantially unchanged. Under the proposed transaction, Son's Trust will be divided, but the beneficiaries' interests in the property will not change in kind or extent and no new interests will be created. Under these circumstances, the interests of the beneficiaries of the Subtrusts will not differ materially from their respective interests in Son's Trust.

Accordingly, based on the facts submitted and the representations made and assuming Court issues the requested order and that the proposed division of Son's Trust is carried out, and is effective, under State law, we conclude that the proposed non pro-rata apportionment and division of Son's Trust under the judicial reformation will not result in a material difference in kind or extent of the legal entitlements enjoyed by the beneficiaries and will not result in recognition of gain or loss under § 1001.

Except as specifically ruled herein, we express no opinion on the federal tax consequences of the proposed modifications and division 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,

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George Masnik, Chief  
Branch 4  
Office of Associate Chief Counsel  
(Passthroughs and Special  
Industries)

Enclosure

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