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Person To Contact:
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LEGEND:

Settlor =
Child A =
Child B =
Child C =
Child D =
Child E =
Trust =
Corporate Trustee =
Trustee =
Local Court =

State =
State Statute =
Charity =
Date 1 =

Dear :

This responds to your letter of May 6, 2005, requesting rulings concerning the income and generation-skipping transfer (GST) tax consequences of a proposed partition of a trust.

FACTS

On Date 1, Settlor created an irrevocable trust, Trust, for the benefit of his children, Child A, Child B, Child C, Child D, and Child E. Date 1 is prior to September 25, 1985, and no additions have been made to Trust since September 25, 1985. The trustees of Trust are Corporate Trustee and Trustee (together "Trustees").

Article 2, § 2.02(1) of Trust provides that, during the life of Settlor's five children and during the lifetime of the survivors and the survivor of them, the Corporate Trustee has the discretion to distribute net income to any one or more of Settlor's children according to their needs or the income may be accumulated, in whole or in part, and added to trust principal. Such payments to Settlor's children need not be equal among the children, and any payment shall not affect the eventual division of Trust's principal.

Article 2, § 2.02(2) provides that during the lifetime of Settlor's five children and during the lifetime of the survivors and the survivor of them, the Corporate Trustee may make discretionary distributions of principal to any one or more or all of Settlor's children for any purpose. Such principal payments need not be equal among the children and shall not affect the eventual division of Trust's principal.

Pursuant to Article 2, § 2.02(3), each child is granted a special testamentary power of appointment over one-fifth of Trust's principal. Said power may be exercised only in favor of the child's surviving spouse if the child leaves surviving issue, the child's issue, and the Settlor's issue. In default of the exercise of such power by a child, the principal that was subject to the power is to remain in Trust. After the death of the last of Settlor's children, any property remaining in Trust is to be distributed to Settlor's then living issue, per stirpes, and if no issue of the Settlor is then living, the principal is to be distributed to Charity. Child A, Child B, Child C, Child D, and Child E are all living.

Article 3, § 3.01 provides that each trust, if not sooner terminated pursuant to other provisions of Trust, shall terminate twenty-one years after the death of the survivor of a class consisting of Settlor's issue living at the date of the execution of Trust, Settlor's sons-in-law and Settlor's daughter-in-law.

Article 4, § 4.04 grants the Trustees certain powers exercisable without approval or order of any court. Section 4.04 (9) specifically authorizes the Trustee or Trustees to divide Trust's assets.

Trust is governed by the laws of State. State Statute provides that a trustee may, without the approval of any court, divide a trust into two or more separate trusts if the trustee determines that dividing the trust is in the best interests of all persons interested in the trust and will not substantially impair the accomplishment of the purposes of the trust.

The Trustees intend to partition Trust pursuant to the authority granted to them by State Statute and § 4.04(9) of the trust instrument into five separate trusts, one each for the benefit of each of Settlor's five children. In addition, the Trustees will seek a court order from Local Court approving the proposed partition.

The terms of each separate trust will remain the same as Trust except that each new trust will provide that the net annual income, accumulations of income, and principal shall be distributed from time to time in such amounts and at such times as determined by the

Corporate Trustee, in its discretion, to the child for whom that separate trust is held without regard to distributions from any other trust. Upon the death of a child, the separate trust held for that child will be distributed to any one or more members of the group consisting of such child's surviving spouse if such child leaves issue surviving him or her, such child's issue, and the other issue of the Settlor, in such amounts and proportions and for such estates and interests and outright or upon such terms, trusts, conditions and limitations as such child shall appoint by a will referring specifically to this limited power of appointment; provided, however, that in no event shall such child exercise this limited power of appointment in favor of himself or herself, his or her creditors, his or her estate, or the creditors of his or her estate.

Upon the death of a child of the Settlor who has not exercised his or her limited power of appointment, the separate trust held for that child will continue to be held in trust for that child's issue until the last of the Settlor's children is deceased. Upon the death of the last of the Settlor's children, any of the five trusts that are still in existence will terminate and the assets of each trust will be distributed to the then living issue, per stirpes, of the child for whom the separate trust was held, provided, however, that if such child has no issue then living, such assets shall be distributed to the then living issue of the Settlor, per stirpes, but if no issue of the Settlor is then living, the principal is to be distributed to Charity.

You have requested the following rulings:

1. That the partition of Trust will, by reason of § 1433(b)(2)(A) of the Tax Reform Act and § 26.2601-1(b)(1)(i), neither subject the newly partitioned trusts to the GST tax imposed by § 2601 nor cause distributions to skip persons or terminations of interests of non-skip persons to be taxed as generation-skipping transfers.
2. That the partition of Trust will not constitute an actual or constructive addition to the newly partitioned trusts in accordance with a § 26.2601-1(b)(1)(v).
3. That the partition of Trust will not cause Trust, the newly partitioned trusts or any beneficiary to realize any gain or loss from a sale or other disposition of property under § 61 or § 1001.

Rulings 1 and 2—Generation-Skipping Transfer Tax

Section 2601 of the Internal Revenue Code imposes a tax on each generation skipping transfer. Under § 1433(b)(2)(A) of the Tax Reform Act of 1986 (the Act) and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the GST tax does not apply to any generation-skipping transfer under a trust that was irrevocable on September 25, 1985.

Section 26.2601-1(b)(1)(ii)(A) provides that any trust in existence on September 25, 1985, will be considered an irrevocable trust except as provided in § 26.2601-1(b)(1)(ii)(B) or (C) (relating to property includible in the grantor's gross estate under §§ 2038 and 2042).

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. The rules contained in the paragraph are generally applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. Unless specifically provided otherwise, 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 of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, 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.

Section 26.2601-1(b)(4)(i)(E), Example 5, describes 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 example concludes that 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 this case, Trust was irrevocable on September 25, 1985. It is represented that there have been no actual or constructive additions to Trust after September 25, 1985. The

proposed division of Trust into five separate trusts is similar to the modification described in § 26.2602-1(b)(4)(i)(E), Example 5. The proposed modification will not shift a beneficial interest in Trust to a beneficiary who occupies a lower generation than the person who held beneficial interests prior to the modification. In addition, the modification will not extend the time for vesting of any beneficial interests beyond the period provide in Trust. Therefore, based on the facts submitted and representations made, we conclude that the proposed partition of Trust will neither subject the newly partitioned trusts to the GST tax imposed by § 2601 nor cause distributions to skip persons or terminations of interests of non-skip persons to be taxed as generation-skipping transfers. Furthermore, the proposed modification will not constitute an actual or constructive addition to the newly partitioned trusts under § 26.2601-1(b)(1)(v).

Ruling 3—Income Tax

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

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

The Supreme Court of the United States in Cottage Savings, 499 U.S. at 560-61, 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.

It is consistent with the Supreme Court's opinion in Cottage Savings to find that the interests of the beneficiaries of the newly partitioned trusts will not differ materially from their interests in Trust. In the proposed transaction, Trust will be severed in accordance with the power conferred on the Trustees under the trust document and applicable state law. Except for the changes described above, all other provisions of Trust 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 Trust for purposes of § 1001(a).

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.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the materials submitted in support of the request for rulings, it is subject to verification on examination.

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 the taxpayer.

Sincerely yours,

Katherine A. Mellody
Senior Technician Reviewer, Branch 4
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure
Copy for section 6110 purposes
cc: