Internal Revenue Service

Department of the Treasury

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Person to Contact:

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LEGEND:

Trust =

A =

B =

a =

b =

c =

d =

e =

f =

g =

h =

i =

C =

D =

E =

F =

j =

k =

l =

m =

n =

o =

p =

q =

r =

s =

t =

Corporations =

u =

v =

w =

x =

Dear Sir and Madam:

In a letter, dated May 29, 1998, you requested rulings concerning the income and generation-skipping transfer (GST) tax consequences of the proposed partition of the Trust. This letter responds to your request.

The information submitted and the representations made are summarized as follows: A and B established the Trust on a. A and B could amend, modify, or revoke the entire Trust by mutual written agreement; however, each acting alone could amend only the dispositive provisions of her share. The Trust was amended on b, c, d, e, f, and was finally amended in its entirety on g. A died on h, and B died on i.

Article First of the Trust directs the trustees to divide all of the property held in the Trust into two unequal shares, allotting one share for the benefit of A (the A Share) and one share for the benefit of B (the B Share). Article Second provides that the trustees are to pay to each of A and B (the Donors), the net income from their respective shares of the Trust in quarter-annual payments so long as she lives or until the Trust is terminated.

Article Third of the Trust provides that the Trust is to terminate on the death of the last survivor of A, B, C (B's husband), D, E, and F. The share of each Donor is to be paid over free and discharged of all trusts to the then beneficiary or beneficiaries of the share.

Article Fourth of the Trust provides that following A's death, the trustees are to pay the net income from the A Share as follows, in quarter-annual payments:

1. For and during the natural lives of A's sons, E and F, j to each.

2. For and during the natural life of either E or F, should either of them die leaving no issue, his share to the survivor.

3. For and during the natural life of either E or F, should either of them die leaving issue, the share of the income of the son so dying to the issue of that son in equal shares.

Article Fifth of the Trust provides that following the death of B, the trustees are to pay the net income from the B Share as follows, in quarter-annual payments:

1. For and during the natural life of C and of D, k to C and l to D.

2. For and during the natural life of C, if D does not survive C, m to C.

3. For and during the natural lives of A and D, if C does not survive them, n to A and o to D.

4. For and during the natural life of A, if C and D do not survive A, p to A.

5. For and during the natural life of E and F , if C and A do not survive them, o to D, o to E, and o to F.

6. For and during the natural life of E and F, should all three of C, D, and A fail to survive them, j to E and j to F.

7. For and during the natural life of E and F, should both C and A fail to survive them, and should one of E and F dies, leaving no issue, his share to the survivor.

8. For and during the natural life of E and F, should both C and A fail to survive them, and should one of E and F die leaving issue, the share of the income of deceased one of E and F to the issue of the deceased one in equal shares.

Article Sixth of the Trust provides that on the death of A and the death of B, C, D, E, and F, the trustees are to pay the balance of the A share, together with accumulated income, free and discharged of all trusts, to the surviving issue of E and F in equal shares.

Article Sixth of the Trust further provides that on the death of B, C, A, D, E, and F, the trustees are to pay the balance of the B share, together with accumulated income, free and discharged from all trusts, to the surviving issue of E and F in equal shares.

A, B, C, D, and E are deceased. E had q children, r of whom died without issue and s of whom are living. F has t children, all of whom are living. Since E's death, j of the net income of each of the A share and the B share has been paid to F and j has been paid in equal shares to E's living children. The property of each share consists entirely of stock of the Corporations. Several of E's children are currently employed by the Corporations and want to continue to operate them. F and F's children are not employed by the Corporations and want the Trust to diversify its investments.

It is represented that the beneficiaries disagree concerning the intent of Article Sixth of the Trust relating to the disposition of the Trust property on the termination of the Trust. Specifically, it is unclear whether A and B intended that on the termination of the Trust the Trust property is to be distributed: (1) j by right of representation to E's then living issue and j by right of representation to F' then living issue, or (2) in equal shares, one share to each child of E and each child of F who is then living and one share by right of representation to the then living issue of each child of E and each child of F who is then deceased with issue then living. F's children believe that the trust property should be distributed in two equal shares, one share for E's family and one share for F's family. E's children, on the other hand, believe that, if F were to die today, the Trust property should be distributed in u equal shares, one for each living child of E and F.

In order to resolve the controversy concerning the intent of the Trust without incurring the costs and delay of a contested court proceeding, the trustees, F, F's children, and E's children executed a Compromise Agreement, dated v. Under the

Compromise Agreement, the property in each of the A Share will be divided pro rata into two equal shares, the A Share for E and the A Share for F. The B Share also will be divided pro rata into two equal shares, the B Share for E and the B Share for F.

During F's lifetime, the net income of the A Share for E and the B Share for E will be paid quarterly by right of representation to E's then living issue. On F's death, any balance of the net income of the A Share for E and the B Share for E is to be added to the principal of each Share and is to be distributed in equal shares, one share to each child of E who is then living and one share by right of representation to the then living issue of each child of E who is then deceased with issue then living.

During F's lifetime, the net income of the A Share for F and the B Share for F is to be paid quarterly to F. On F's death, any balance of net income of the A Share for F and the B Share for F is to be added to principal of each Share, and the then remaining principal of each Share is to be distributed as follows:

(a) w thereof in equal shares, one share to each child of F who is then living and one share by right of representation to the then living issue of each child of F who is then deceased with issue then living; and

(b) x thereof in equal shares, one share to each child of E who is then living and one share by right of representation to the then living issue of each child of E who is then deceased with issue then living.

The trustees for the A Share for E and the B Share for E will remain the same. The Compromise Agreement, however, provides for the appointment of new trustees for the A Share for F and the B Share for F.

The trustees also entered into a Redemption Agreement, dated v, with each of the Corporations. Under the Redemption Agreement, each of the Corporations agreed to redeem its stock held by the A Share for F and the B Share for F.

It is represented that the A Share became irrevocable at A's death on h, and there have been no additions to the A Share since September 25, 1985. It is represented that the B Share is exempt from the GST tax because B and C each allocated their GST exemption to the B Share in amounts sufficient to exempt it in full.

You have requested the following rulings:

1. Neither the partition of the A share and the B share into equal shares for E and F , the redemption of the stock held by the A Share for F and the B Share for F as provided in the Redemption Agreement, nor the distribution of those shares as provided in the Compromise Agreement will be construed as a constructive addition to the Trust or otherwise affect the Trust's exemption from the GST tax.

2. The partition and distribution provided for in the Compromise Agreement will not result in a taxable gift by any beneficiary.

3. The partition and distribution provided for in the Compromise Agreement will not result in the realization of gain or loss to the Trust or to any of the beneficiaries for income tax purposes.

Ruling No. 1:

Section 2601 imposes a tax on every generation-skipping transfer made by the "transferor" to a "skip-person."

Section 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax regulations provides that the tax does not apply to any generation-skipping transfer under a trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985. The rule of the preceding sentence does not apply to a pro rata portion of any generation-skipping transfer under an irrevocable trust if additions are made to the trust after September 25, 1985.

Section 26.2601-1(b)(1)(ii) provides that, except as provided in § 26.2601-1(b)(1)(ii)(B) or (C), any trust in existence on September 25, 1985, is considered an irrevocable trust.

Section 2611(a) defines the term "generation-skipping transfer" as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 26.2611-1 provides that a generation-skipping transfer is an event that is either a direct skip, a taxable distribution, or a taxable termination. The determination as to whether an event is a generation-skipping transfer is made by reference to the most recent transfer subject to the estate or gift tax.

Section 2612(c)(1) defines the term "direct skip" to mean a transfer subject to a tax imposed by chapter 11 or 12 of an interest in property to a skip person.

Section 2613(a) defines the term "skip person" to mean --

(1) a natural person assigned to a generation that is two or more generations below the generation assignment of the transferor, or

(2) a trust --

(A) if all interests in such trust are held by skip persons, or

(B) if --

(i) there is no person holding an interest in the trust, and

(ii) at no time after such transfer may a distribution (including distributions on termination) be made from such trust to a non-skip person.

Generally, modifications that change the quality, value, or timing of any beneficial interests, rights or expectancies originally provided for under the terms of a trust instrument will cause a trust that is otherwise exempt from the GST tax to lose its exempt status.

We have examined the proposed Compromise Agreement and the Redemption Agreement in the context of relevant case law that applies to this case. The Compromise Agreement appears to provide an allocation of trust corpus that is within the range of reasonable settlements considering the issue presented. We have determined that the terms of the proposed Compromise Agreement fairly reflect the relative merits of the contentions of the respective parties to the dispute. Accordingly, we conclude that neither the partition of the A share and the B share into equal shares for E and F , the redemption of the stock held by the A Share for F and the B Share for F as provided in the Redemption Agreement, nor the distribution of those shares as provided in the Compromise Agreement will be construed as a constructive or actual addition to the Trust or otherwise affect the Trust's exemption from the GST tax.

Ruling No. 2:

Section 2501(a) imposes a tax for each calendar year on the transfer of property by gift during the calendar year by any individual, resident or nonresident.

Section 2511(a) 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 the gift is made in property, the value thereof at the date of the gift is considered the amount of the gift.

Section 2512(b) provides that where property is transferred for less than an adequate and full 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, and is included in computing the amount of gifts made during the calendar year.

Based on the information submitted and the representations made, we conclude that the partition and distribution provided for in the Compromise Agreement will not result in any change in the quality, value, or timing of any of the powers, beneficial

interests, rights, or expectancies originally provided. Accordingly, the Compromise Agreement will not result in a taxable gift by any beneficiary.

Ruling No.3:

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss from the sale or other disposition of property is the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized. Section 1001(c) provides that generally the entire amount of gain or loss on the sale or exchange of property is recognized.

Section 1.1001-1(a) of the Income Tax Regulations provides, as a general rule, that except as otherwise provided in subtitle A, the gain or loss realized from the conversion of property into cash, or the exchange of property for other property differing materially either in kind or in extent, is treated as income or loss sustained. Exchanged properties are materially different when they embody legal entitlements "different in kind or extent" or they confer "different rights and powers." Cottage Savings Association v. Commissioner, 499 U.S. 554, 565 (1991).

Thus, two elements must exist for an "exchange" to be a § 1001 taxable event. First, the transaction must actually be an exchange (or some other type of disposition). Second, the property received must be materially different in kind or in extent from that which was given up.

We have examined the proposed Compromise Agreement in the context of the relevant case law, including Lyeth v. Hoey, 305 U.S. 188 (1938). Based on the taxpayers' representations, the Compromise Agreement appears to reflect the resolution of a bona fide dispute, to provide an allocation of principal of the Trust that is within the range of reasonable settlements considering the issue in dispute, and to fairly reflect the relative merits of the contentions of the parties to the dispute.

Based on the information submitted, we conclude that the partition of the A Share into the A Share for E and the A Share for F, the partition of the B Share into the B Share for E and the B Share for F, the distribution of the assets of the A Share to the A Share for E and the A Share for F, and the distribution of the assets of the B Share to the B Share for E and the B Share for F, as provided in the Compromise Agreement, will not result for income tax purposes in the realization of gain or loss to the Trust or to any of its beneficiaries. This is because the interests of the Trust beneficiaries in the four new shares will be deemed to be the interests that they had in the two original shares as of the times that the application of the provisions of the Trust to the A Share and the B Share first became irrevocable. Accordingly, no exchanges will have taken place as a result of the partitions and distributions reflected in the Compromise Agreement because no beneficiary will be deemed to have received any new property

and those partitions and distributions will not result in the realization of gain or loss to the Trust or to any of the beneficiaries for income tax purposes.

However, we specifically do not rule that distributions subsequently made from the A Share for E, the A Share for F, the B Share for E, and the B Share for F to their beneficiaries will not result in income tax consequences to their distributors or distributees. Such consequences will be determined in accordance with Subchapter J of Internal Revenue Code."

Except as expressly in this letter, we express or imply no opinion the concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter under the cited provisions of the Code or any other provisions of the Code.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Christine E. Ellison
Chief, Branch 7
Office of Assistant Chief Counsel
(Passthroughs and Special Industries)