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TOPIC: IRS Rules that Trust Modification and Division Will Not Result in Income, Gift, or Estate Tax Consequences

Upon termination of a GRAT, a remainder trust was created for the benefit of the grantor's two sons. The trustees wanted to divide the remainder trust into separate trusts for each son pursuant to applicable state law, which allowed (1) modification of a non-charitable irrevocable trust with the consent of the trustee and all beneficiaries if the court concluded that modification was not inconsistent with a material purpose of the trust and (2) division of a trust into separate trusts on petition by a trustee or beneficiary if the court was satisfied the division would not defeat or materially impair the accomplishment of trust purposes or interests of the beneficiaries. Upon division of the remainder trust, the trustees would fund the separate successor trusts with a pro-rata portion of each asset of the remainder trust property. Under these facts, the IRS ruled that, after the trust modification and division: (1) no beneficiary's interest in the trusts would change and so there would be no transfer of property subject to gift tax; (2) no portion of the trusts' property would be includible in a beneficiary's estate; (3) no income realization, gain, or loss would result with respect to a trust or any beneficiary; (4) the successor trusts would be treated as separate trusts for federal income tax purposes; and (5) the basis of the property in the successor trusts would be the same as the Initial Trusts. See PLR 201722007.

[View PLR 201722007](#)

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Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Release Date: 6/2/2017

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2038.00-00, 2501.00-00,
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Person To Contact: _____, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B04 – PLR-125870-16
PLR-125871-16

Date: February 16, 2017

Legend

Date 1 =
Date 2 =
Date 3 =
Grantor =
Trustee =
Trustee =
GRAT =

Trust 1 =

Trust 2 =

State =
Co-Trustees =
Son 1 =
Son 2 =
Corporation =
State Statute 1 =
State Statute 2 =

Court =

Dear _____ :

This letter responds to correspondence, dated August 17, 2016 requesting rulings regarding the income, gift, and estate tax consequences of a proposed modification of two trusts.

The facts submitted and the representations made are as follows. Grantor is a resident of State. Grantor has two sons, Son 1 and Son 2. Both sons are under the age of 35. Grantor has no other children, deceased children, grandchildren, or more remote descendants. No additional children are expected to be born to Grantor.

On Date 1, Grantor created a Grantor Retained Annuity Trust ("GRAT"). The retained term expired on Date 2 at which time the remaining assets in GRAT became subject to a continuing trust, Trust 1, for Grantor's two sons.

On Date 2, GRAT owned shares in Corporation, an S corporation. In order to allow continued qualification as an S corporation shareholder, the Co-Trustees, pursuant to paragraph 5.16 of GRAT, divided the shares in Corporation into a separate trust, Trust 2, and made an electing small business trust ("ESBT") election consistent with § 1361(e). Spouse and Corporate Trustee are Co-Trustees of Trust 1 and Trust 2 (collectively "Trusts").

Pursuant to Article Second, paragraph 2.1(a), until the earlier of (a) the death of the last living child of Grantor, or (ii) the date upon which the youngest living child of Grantor attains the age of 35 (the "Original Division Date"), the Co-Trustees of Trust 1 are to pay to or apply for the benefit of Son 1 and Son 2 so much of the income or principal as may be necessary for their health, education, maintenance, and support.

Paragraph 2.1(b) provides that upon the Original Division Date, the Co-Trustees of Trust 1 are directed to distribute principal of the trust to Grantor's lineal descendants, subject to the equalization provision in paragraph 2.1(b)(1) (the "Equalization Distribution"). The Equalization Distribution requires the Co-Trustees of Trust 1 to first distribute to Son 1 cash, securities, and/or other property to take into account the value of certain gifts made to Son 2 prior to GRAT's creation. After the Equalization Distribution to Son 1, the balance of Trust 1 is divided equally between Son 1 and Son 2, if both sons are living on the Original Division Date.

Paragraph 2.1(b) also provides that if either son predeceases the Original Division Date, his descendants, if any, will take in *per stirpes* shares the property that such deceased son would have received if he was then living. If a son predeceases the Original Division Date without any surviving descendants, the other son (or his

descendants, if any) will take the property of the deceased son. If both sons predecease age 35 without surviving descendants, upon the death of the last son to die, the remaining trust property passes to the descendants of Grantor's siblings. These beneficiaries are referred to as "contingent beneficiaries."

Trust 2 provides nearly identical terms to those in Trust 1, including an equalizing distribution.

State Statute 1 provides that a noncharitable irrevocable trust may be modified on consent of the trustee and all beneficiaries if the court concludes that modification is not inconsistent with a material purpose of the trust.

State Statute 2 provides, in relevant part, that a trust may be divided into two or more separate trusts on petition by a trustee or beneficiary if the court is satisfied that such division will not defeat or materially impair the accomplishment of trust purposes or interests of the beneficiaries.

The Co-Trustees of Trust 1 and the Trust 2 propose to modify Trusts to vest an independent trustee with discretion to divide Trusts' assets into two separate trusts ("Successor Trusts"), where each Successor Trust will benefit one of Grantor's sons, and the descendants of such son if he dies before attaining the age of 35. Provided a son survives to age 35, only that son would be eligible for distributions from his Successor Trust. If a son dies prior to age 35, his descendants, if any, would be eligible to receive the remainder of that son's Successor Trust, or if such son has no descendant then living, the remainder interest would pass to his brother, or the brother's descendants, if any. If both sons predecease the age of 35 years without leaving any surviving descendants, the same contingent beneficiaries receive the remainder of their Successor Trusts.

Successor Trusts provide for a Final Distribution Date which is defined as the earlier of (a) the death of the last living child of Grantor, or (ii) the date upon which the youngest living child of Grantor attains the age of 35. The modifications and any future divisions of the Trusts are pursuant to authority granted under State Statutes 1 and 2 and only after approval by a court of competent jurisdiction in State.

Pursuant to the modifications of Trusts, the Co-Trustees will have the authority to establish and fund Successor Trusts prior to the Original Division Date in part or in whole at any time the Co-Trustees deem appropriate. When funding Successor Trusts, the Co-Trustees shall first satisfy the Equalization Distribution owed to the Successor Trust for Son 1's benefit.

The provisions of each Successor Trust will continue to be governed by the terms of Trusts, except that as long as there are any living descendants of Son 1 or Son 2, distributions of income and principal will be limited to the son and descendants of that particular son's family line. Pursuant to Successor Trusts, Son 1 may become the sole trustee of his trust and Son 2 may become the sole trustee of his trust. In all other respects, the terms of Successor Trusts will be identical to Trusts.

After satisfying the Equalization Distribution, if and when the Co-Trustees decide to distribute any remaining assets in funding the Successor Trusts, the Co-Trustees of the Trusts will fund the Successor Trusts by allocating a pro-rata portion of each and every asset of the post-equalization property between the Successor Trusts.

The Co-Trustees filed petitions for the modifications of Trusts with Court, to which all beneficiaries consented. On Date 3, Court issued orders (Orders) approving the modifications of Trusts effective upon the receipt of a private letter ruling from the Internal Revenue Service.

Co-Trustees petitioned to modify Trusts for the following reasons: (i) The modifications will provide for the Grantor's sons in a manner that equalizes Son 1 for certain gifts made to Son 2 prior to GRAT's creation on Date 1; (ii) The formula is complicated and will become progressively more complicated with the passage of time. (iii) The modifications will allow each son to participate in the management of his own trust, as trustee, enhancing each son's financial acumen and experience; and (iv) The Equalization Distribution will trigger income taxes and the modifications will avoid waiting longer to fund the Equalization Distribution which would further exacerbate the potential income tax liability.

You have requested the following rulings:

1. The modifications of Trusts and any future divisions of Trusts into Successor Trusts will not create or result in a transfer of property subject to federal gift tax under § 2501 of the Internal Revenue Code.
2. The modifications of Trusts and any future divisions of Trusts into Successor Trusts will not cause any portion of the assets of Trusts or Successor Trusts to be includible in the gross estate of any beneficiary under § 2035, 2036, 2037, or 2038.
3. The Successor Trusts will be treated as separate trusts for federal income tax purposes pursuant to § 643(f).
4. The modifications of Trusts and any future divisions of Trusts into Successor Trusts will not result in treating any property as paid, credited, or distributed for

purposes of § 661 or § 1.661(a)-2(f) of the Income Tax Regulations, and so will not result in realization of any income, gain, or loss under § 661 or § 662 by Trusts, Successor Trusts, or a beneficiary of the trusts. In addition, the modifications of Trusts and any future divisions of Trusts into Successor Trusts will not result in the realization of any income, gain or loss to Trusts, Successor Trusts, or a beneficiary of those trusts under § 61 or § 1001, except to the extent the Equalization Distribution is funded in kind with appreciated property.

5. The modifications of Trusts and any future divisions of Trusts into Successor Trusts will result in each Successor Trust holding its share of the respective Trust's property with the same basis as it had when owned by such Trust at the time of division into a Successor Trust under § 1015, except to the extent the Equalization Distribution is funded in kind with appreciated property.

RULING 1

Section 2501 imposes a tax for each calendar year on the transfer of property by gift during such calendar year by any individual.

Section 2511(a) provides that the gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property transferred is real or personal, tangible or intangible.

Section 25.2511-1(a) of the Gift Tax regulations provides that the gift tax applies to a transfer by way of gift 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 25.2511-1(c)(1) provides that the gift tax also applies to gifts indirectly made. Any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax.

Section 25.2511-1(c)(2) provides, in relevant part, except in the case of a qualified disclaimer, any disposition by a beneficiary, heir or next-of-kin whereby ownership is transferred gratuitously to another constitutes the making of a gift by the beneficiary, heir or next-of-kin.

Section 25.2511-1(g)(1) provides that donative intent on the part of the transferor is not an essential element in the application of the gift tax to the transfer. The application of the tax is based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor. However, there are certain types of transfers to which the tax is not applicable.

It is applicable only to a transfer of a beneficial interest in property. It is not applicable to a transfer of bare legal title to a trustee. A transfer by a trustee of trust property in which he has no beneficial interest does not constitute a gift by the trustee.

In this case, the modifications of Trusts and any future division of Trust 1 and Trust 2 into Successor Trusts pursuant to Court Orders do not increase, decrease, or otherwise change any beneficiary's beneficial interest in Trusts. Accordingly, based upon the facts submitted and the representations made, the modifications of Trusts and any future divisions of Trust 1 and Trust 2 into Successor Trusts will not create or result in a transfer of property subject to federal gift tax under § 2501.

RULING 2

Section 2033 provides that the value of the gross estate includes the value of all property to the extent of the interest therein of the decedent at the time of his death.

Section 2035(a) provides that if (1) the decedent made a transfer (by trust or otherwise) of an interest in property, or relinquished a power with respect to any property, during the three-year period ending on the date of the decedent's death, and (2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under § 2036, 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death, the value of the gross estate shall include the value of any property (or interest therein) that would have been so included. Under § 2035(b), the amount of the gross estate shall be increased by the amount of any gift tax paid by the decedent or his estate on any gift made by the decedent or his spouse during the 3-year period ending on the date of the decedent's death.

Section 2036(a) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate consideration in money or money's worth), by trust or otherwise, under which the decedent has retained for his life or for any period not ascertainable without reference to the decedent's death or for any period which does not in fact end before the decedent's death (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Section 2037(a) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, if (1) the possession or

enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent, and (2) the decedent has retained a reversionary interest in the property and the value of the reversionary interest immediately before the death of the decedent exceeds 5-percent of the value of the property.

Section 2038(a)(1) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of the decedent's death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.

In order for §§ 2035 through 2038 to apply, a decedent must have made a transfer of property or any interest therein (except in the case of a bona fide sale for an adequate consideration in money or money's worth) under which the decedent retained an interest in, or power over, the income or corpus of the transferred property. The beneficiaries of Trusts and Successor Trusts will have the same interests after the modification of Trusts and any future division of Trusts into Successor Trusts as they have prior to the modifications and divisions. Therefore, nothing will be transferred by them by reason of the modifications of Trusts and any future divisions of Trusts into Successor Trusts. Accordingly, based upon the facts submitted and the representations made, we conclude that the modifications of Trusts and any future divisions of Trust 1 and Trust 2 into Successor Trusts will not cause any portion of the assets of Trust 1 or Trust 2 or Successor Trusts to be includible in the gross estate of any beneficiary under § 2035, 2036, 2037 or 2038 in the event that either Son 1 or Son 2 (or any other beneficiary) dies before the Final Division Date.

RULING 3

Section 643(f) provides that, for purposes of subchapter J of chapter 1 of subtitle A, 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 the tax imposed by chapter 1.

Section 1806(b) of the Tax Reform Act of 1986 provides that § 643(f) shall apply to taxable years beginning after March 1, 1984; except that, in the case of a trust that

was irrevocable on March 1, 1984, it shall apply only to that portion of the trust that is attributable to contributions of corpus after March 1, 1984.

Taxpayer represents that each Successor Trust will have different beneficiaries. Based on the facts submitted and the representations made, we conclude that as long as the Successor Trusts are separately managed and administered, they will be treated as separate trusts for federal income tax purposes.

RULING 4 (Part 1)

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

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

Section 1001(b) provides 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 any property (other than money) received. Under § 1001(c) the entire amount of gain or loss on the sale or exchange of property shall be recognized, except as otherwise provided.

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

An exchange of property results in the realization of gain under § 1001 if the properties exchanged are materially different. *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991). A material difference when the exchanged properties embody legal entitlement different in kind or extent, or if they confer different rights and powers. *Id.* at 565.

Section 1.1001-1(h) provides that the pro-rata division or severance of any trust pursuant to authority in an applicable state statute or pursuant to the governing instrument is not an exchange of property differing materially either in kind or extent

If the Trusts are divided into Successor Trusts, the Co-Trustees of Trusts will allocate assets of Trusts to the Successor Trusts on a pro-rata basis after satisfying the Equalization Distribution with respect to Son 1's Successor Trust. The division of Trusts

into the Successor Trusts serves primarily to effect the terms of GRAT and does not change the interests of the beneficiaries.

Accordingly, based on the facts submitted and representations made, we conclude that the modifications of Trusts and any future divisions of Trusts into Successor Trusts pursuant to the modified terms of Trusts will not result in the realization of any income, gain, or loss to Trusts, Successor Trusts, or a beneficiary of any of those trusts under § 61 or § 1001 as a result of the division, except to the extent the Equalization Distribution is funded in kind with appreciated property.

RULING 4 (Part 2)

Section 661(a) provides that in any taxable year a deduction is allowed in computing the taxable income of a trust (other than a trust to which subpart B applies), for the sum of (1) the amount of income for such taxable year required to be distributed currently; and (2) any other amounts properly paid or credited or required to be distributed for such taxable year. However, such deduction shall not exceed the distributable net income (DNI) of the estate or trust.

Section 1.661(a)-2(f) provides that gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of a distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount, of specific property other than that distributed, or of income as defined under § 643(b) and the applicable regulations, if income is required to be distributed currently.

Section 662(a) provides that there shall be included in the gross income of a beneficiary to whom an amount specified in § 661(a) is paid, credited, or required to be distributed (by an estate or trust described in § 661), the sum of the following amounts: (1) the amount of income for the taxable year required to be distributed currently to such beneficiary, whether distributed or not; and (2) all other amounts properly paid, credited, or required to be distributed to such beneficiary for the taxable year.

Rev. Rul. 82-4, 1982-1 C.B. 99, addresses the income tax results of the distribution of an estate residue between two children, when one of two children is to be first equalized for the value of a lifetime transfer to the other child. The ruling holds that such equalizing distribution is a distribution in satisfaction of a right to receive a specific dollar amount, and the estate may realize gain on distribution of appreciated property in kind in satisfaction of that amount.

In accordance with the conclusion that the post-equalization property divisions of Trust 1 and Trust 2 will not result in gain or loss under § 61 or § 1001, we also conclude that, based solely on the facts submitted and representations made, the proposed

divisions of the post-equalization property will not result in income, gain or loss to the trusts under § 661, § 662, or § 1.661(a)-2(f). Consistent with Rev. Rul. 82-4, gain will be recognized on funding of Successor Trusts to the extent appreciated assets are used to satisfy the Equalization Distribution in kind.

RULING 5

Section 1015(a) provides that if the property was acquired by gift, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that if the basis (adjusted for the period before the date of the gift as provided in § 1016) is greater than the fair market value of the property at the time of the gift then for the purpose of determining loss the basis shall be the fair market value.

Section 1.1015-2(a)(1) provides that in the case of property acquired after December 31, 1920, by transfer in trust (other than by a transfer in trust by gift, bequest, or devise) the basis of property so acquired is the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on the transfer under the law applicable to the year in which the transfer was made. If the taxpayer acquired the property by a transfer in trust, the basis applies whether the property be in the hands of the trustee, or the beneficiary, and whether acquired prior to the termination of the trust and distribution of the property, or thereafter.

Based on the facts submitted and representations made, we conclude the modifications of Trusts and any future divisions of Trusts into Successor Trusts will result in each Successor Trust holding its share of the respective Trust's property with the same basis as it had when owned by such Trust at the time of division into a Successor Trust under § 1015, except to the extent the Equalization Distribution is funded with appreciated property in kind.

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.

PLR-125870-16
PLR-125871-16

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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,
Lorraine E. Gardner
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Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure:
Copy for section 6110 purposes