Leimberg Information Services, Inc.

Steve Leimberg's Estate Planning
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Subject: Chuck Rubin on PLRs 201702005 & 201702006: IRS Permits Trust Division without Adverse Federal Tax Consequences

"A problem with 'pot' trusts is the justifiable concern by beneficiaries that discretionary distributions or other actions by a trustee that benefit a member of one beneficiary or family group injure the interests of other beneficiaries or family groups. The easiest solution is to divide the trust into separate trust or trust shares, divided along family group lines in a manner similar to the division in the proposed ruling request.

Such a division raises questions of GST exemption allocations, GST trust grandfathering, estate taxes, gift taxes, and income taxes. There is no one Internal Revenue Code provision that addresses or facilitates such divisions, such as, by analogy, the corporate reorganization provisions that permit corporations to reorganize themselves without triggering adverse income tax consequences. Instead, these issues must be resolved either by Private Letter Ruling requests and/or reliance on case law where these issues have been litigated.

In Private Letter Rulings 201702005 and 201702006, the IRS favorably ruled on federal tax consequences of a proposed trust division. But for a minor change in facts, the two rulings are identical, so this newsletter will focus only on 201702005."

In his commentary, **Chuck Rubin** reviews the issues raised in Private Letter Rulings 201702005 and 201702006.

Charles (Chuck) Rubin, a board-certified tax attorney, is managing partner of **Gutter Chaves Josepher Rubin Forman Fleisher Miller PA**, a tax, trusts and estates boutique law firm situated in Boca Raton,

Florida (www.floridatax.com). He is an ACTEC and STEP fellow, and a former adjunct professor at the University of Miami School of Law. Chuck has published numerous treatises, manuals, and articles, including two BNA Tax Management portfolios, and articles in Journal of Taxation, Estate Planning, Tax Management Estates, Gifts and Trusts Journal, and Tax Notes. He also authors a popular tax blog at www.RubinonTax.blogspot.com, and speaks regularly at professional meetings and conferences, and was named 2015 & 2017 Attorney of the Year by Best Lawyers in Tax Law for the Miami metropolitan region.

Here is his commentary:

EXECUTIVE SUMMARY:

Two recent private letter rulings permit irrevocable trusts to divide along family group lines on a pro rata basis without jeopardizing grandfathering for GST purposes, nor triggering adverse income, gift or estate tax consequences.

FACTS:

In Private Letter Rulings 201702005 and 201702006, the IRS favorably ruled on federal tax consequences of a proposed trust division. But for a minor change in facts, the two rulings are identical, so we will focus only on 201702005. Two trusts are involved in the ruling – with each trust to be divided pursuant to state statute and court approval. The trusts involved are irrevocable trusts established for the benefit of the descendants of a child of the settlor (A). A has three adult children (B, C & D) and four minor grandchildren. Income is distributable to A's children and the descendants of any deceased child of A (although in one trust such descendants are not included). The trustee has authority to withhold income and accumulate it or later pay it out. The trustee may also distribute principal if needed for care, education and support beyond what is being satisfied by income distributions. One year after A's death the trust principal and accumulated income is to be distributed to A's lineal descendants *per stirpes*. Proposed new subtrusts will be funded by fractionally dividing the existing trust assets of each trust into 3 new subtrusts, one for each of B, C & D. Trust provisions for the subtrusts are similar, but not identical to the existing trusts, subject to the siloing of the interests of B, C & D and their descendants into

separate trusts so as not to be directly impacted by the exercise of trustee discretion outside of their respective silo. The PLR sought rulings to the effect that (a) the new subtrusts will maintain the “grandfathered” trust status of the predecessor trust for GST purposes, (b) each subtrust will be treated as a separate trust for federal income tax purposes, (c) the division will not cause the predecessor trusts nor any new subtrust to recognize gain or loss from a sale or other disposition of property under Code §§61, 662, or 1001, (d) the subtrusts will inherit the tax basis and holding periods of the predecessor trust as to assets received, (e) the division will not result in any assets of the subtrusts being included in the gross estate of their beneficiaries, and (f) the divisions will not result in transfers subject to gift tax. The IRS favorably ruled on all of the requested rulings.

COMMENT:

A problem with “pot” trusts is the justifiable concern by beneficiaries that discretionary distributions or other actions by a trustee that benefit a member of one beneficiary or family group injure the interests of other beneficiaries or family groups. The easiest solution is to divide the trust into separate trust or trust shares, divided along family group lines in a manner similar to the division in the proposed ruling request.

Such a division raises questions of GST exemption allocations, GST trust grandfathering, estate taxes, gift taxes, and income taxes. There is no one Internal Revenue Code provision that addresses or facilitates such divisions, such as, by analogy, the corporate reorganization provisions that permit corporations to reorganize themselves without triggering adverse income tax consequences. Instead, these issues must be resolved either by Private Letter Ruling requests and/or reliance on case law where these issues have been litigated.

In this ruling, there is little that has not been favorably addressed in other prior rulings – typically in piece meal fashion. The ruling is nonetheless of interest since it (a) reflects a continued leniency by the IRS in allowing such pro rata divisions to occur without adverse consequences, and (b) provides a list of key tax issues and the IRS’ thoughts on why such divisions will not trigger negative answers in plain vanilla divisions. The following provides a short overview of the issues raised and the IRS justification for ruling favorably on each.

(a) GST Grandfathering Preserved. The subject trusts will involve generation skipping distributions to grandchildren (and possibly more remote generations) of the settlor. Presently, the trusts are exempt from the GST because they were irrevocable on September 25, 1985, and no additions were made to them after that date. Modifications, judicial constructions, settlement agreements, and other trustee action involving such "grandfathered" trusts run the risk of losing this grandfathered status. Treas. Regs. §26.2601-1(b)(4)(i)(D)(1) generally protects such actions from ending grandfathering status if the action does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person who held that interest before the modification, and the modification does not extend the time for vesting of any beneficial interest beyond the period of the original trust. Treas. Regs. §26.2601-1(b)(4)(i)(D)(2) provides that a shift of beneficial interest to a lower generation can occur if the modification results in either an increase in the amount of a GST transfer or a new GST transfer. Treas. Regs. §26.2601-1(b)(4)(i)(E), Example 5, provides an example of a pro rata trust division that preserves grandfathered status for the successor trusts. Based principally on the current trust divisions being substantially similar to Example 5, the ruling allowed for the continuation of grandfathered status.

Oftentimes, the trust being divided is not a grandfathered trust, but a trust that is wholly or partly exempt due to the prior allocation of generation skipping tax exemption of the settlor(s). Unlike grandfathered trusts, there are no regulatory provisions that provide a safe harbor for the continuation of whole or partially exempt status. Instead, taxpayers will often seek to rely on the principles of the above-described grandfathering regulations by analogy to adopt a position that the successor trusts inherit the whole or partially exempt status of the predecessor trust.

(b) Separate Trusts. Code §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. Code §643(f) does not apply to trusts that were irrevocable on March 1, 1984 except to the extent additions to corpus were made after March 1, 1984. Based on this effective date provision, the ruling provides that Code §643(f) is inapplicable.

(c) No Gain. Non-pro rata distributions from trusts have the potential for being treated as pro rata distributions to beneficiaries and then an exchange of the assets between the trusts which can result in taxable gain or loss. Rev.Rul. 69-486, 1969-2 CB 159. The corollary to Rev.Rul. 69-486 is that a pro rata distribution in kind does not constitute a sale or exchange. Treas. Regs. §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 Code §643(b) and the applicable regulations, if income is required to be distributed currently. Based on the pro rata division involved, and presumably because the division does not come within the circumstances of Treas. Regs. §1.661(a)-2(f), the PLR provides that no gain recognition resulted.

(d) Carryover Basis and Holding Period. Based on there being no recognition of gain or loss under Code §1001, and the provisions of Treas. Regs. §1.1015-2(a)(1), the PLR determined that a pro rata division into subtrusts allows for carryover basis and holding period of trust assets to the new subtrusts. Treas. Regs. §1.1015-2(a)(1) provides that in the case of property acquired by transfer in trust (other than by 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 transfer in trust, this basis applies whether the property is in the hands of the trustee or the beneficiary, and whether acquired prior to termination of the trust and distribution of the property, or thereafter.

(e) No Gross Estate Inclusion. Presumably, the assets of the existing trusts are not subject to gross estate inclusion at the deaths of their beneficiaries. The ruling holds that no inclusion results for the subtrusts under Code §§2035-38 since "the distribution, management, and termination provisions of the [s]ubtrusts will be substantially similar to the current distribution, management, and distribution provisions of the respective [t]rust."

(f) No Taxable Gifts. The PLR provides that because the beneficial interests, rights, and expectancies of the beneficiaries are substantially the same, both before and after the proposed division, no transfer of property will be deemed to occur as a result of the division.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Chuck Rubin

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CITES:

Private Letter Rulings 201702005 and 201702006; Code §§61, 643(b), 643(f), 662, & 1001; Treas. Regs. §§1.661(a)-2(f), 1.1015-2(a)(1), 2035-38, 26.2601-1(b)(4)(i)(D)(1), 26.2601-1(b)(4)(i)(D)(2), 26.2601-1(b)(4)(i)(E), Example 5; Rev.Rul. 69-486, 1969-2 CB 159.