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Robert P. Achenbach, Jr.

Contributing Editor

Dr. Neil E. Harl, Esq.

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Handling the Merger of Trusts

-by Neil E. Harl*

The merger of corporations has long been a significant part of tax law with detailed provisions available to provide guidance to taxpayers and practitioners faced with the merger of corporate entities.¹ Trusts, on the other hand, have not been the subject of such extensive statutory or regulatory attention nor have trust mergers produced significant numbers of litigated cases as guidance.

The pace of issuance of private letter rulings in recent years provides some evidence that trust mergers are becoming increasingly common, however, and are posing important issues for which guidance is sketchy or non-existent.

Trust mergers tend to occur when the grantor, over a period of years, creates multiple trusts either for the same beneficiaries or some subset of beneficiaries, the grantor sets up multiple trusts to carry out charitable objectives and those in charge of administering the trusts conclude that, from the standpoint of administrative costs, a merger is advisable or different grantors create trusts for the same beneficiaries with those in charge concluding that a merger could save significant amounts of administrative costs.

The key questions

Proposed trust mergers often pose questions in six areas – (1) whether the proposed merger will cause any existing trust or resulting trust to recognize gain (or loss) from the disposition of property;² (2) whether the income tax basis of the resulting trust in each asset received from another trust will be the same as the transferring trust's basis in the same asset;³ (3) whether the holding period of each trust in the various assets will be the same as the transferring trust's basis in the assets;⁴ (4) whether the proposed merger will cause any beneficiary of an existing trust or any beneficiary of a resulting trust to have made a gift for purposes of federal gift tax (and state gift tax where state gift taxes are imposed);⁵ (5) whether the proposed merger will be considered a constructive addition for purposes of the generation skipping transfer tax and will subject distributions from the resulting trust to generation skipping transfer tax;⁶ and (6) what the impact will be of the merger on the inclusion ratio⁷ of the resulting trusts.⁸

Gain or loss on merger. In general, gains or losses on property transfer must be recognized if the transfer involves a conversion into cash or from the exchange of property for other property that differs materially in kind or extent from the property given up.⁹ In a landmark 1991 case, the United States Supreme Court held that exchanged properties are materially different if their respective possessors enjoy legal entitlements that are different in kind or extent.¹⁰ In a 2005 letter ruling, the merger of several trusts did not result in material differences in kind or in entitlements of retirement plans held by trusts.¹¹

Therefore, in a trust merger context, if the trust beneficiaries possess the same interest before

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.

and after the merger, the interests of the beneficiaries are not considered to be materially different and a sale or other exchange has not occurred and realized gain is not recognized.¹² As the regulations state, if a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally is treated as the grantor of the transferee trust.¹³ In a 1995 private letter ruling, a merger of trusts did not constitute a taxable event for income tax purposes where the trusts had the same beneficiaries and the terms of the merged trusts were the same.¹⁴

Asset basis. For transfers after December 31, 1920, for a transfer in trust the basis is the same as it would be in the hands of the grantor, increased by the amount of gain recognized or decreased by the amount of loss recognized by the transferor.¹⁵ That is the outcome except for transfers in trust by gift, devise or bequest.¹⁶ Therefore, if there is no recognition of gain or loss, the basis of assets should carry over in the merger into the resulting trust.¹⁷

Holding period. In determining the period for which the taxpayer has held property, however acquired, the holding period by any other person is “tacked on” to the period for which the property is held by the taxpayer if the property has the same basis in the taxpayer’s hands as it would have had in the hands of the other person.¹⁸

Taxable gift. In general, transfers of property for less than adequate and full consideration are a gift to the extent the value of the property exceeds the value of the consideration.¹⁹ However, if the beneficiaries of the resulting trusts have the same interests after the merger as they had as beneficiaries under the existing trusts, in terms of beneficial interests, rights and expectancies, no transfer is considered to have occurred for federal gift tax purposes and hence no taxable gift occurs.²⁰

IRS has ruled that the merger of an irrevocable inter vivos trust into a testamentary trust did not involve a gift where there was no change in the dispositive provisions with respect to the property previously held in the inter vivos trust.²¹ In that ruling, the terms of the two trusts were virtually identical except for a few minor differences in non-dispositive provisions and the merger was motivated by administrative convenience.²² Similarly, the division of a testamentary trust on a pro rata basis did not result in a gift where the division was in accord with the decedent’s will and a court order.²³ In a 1946 Tax Court case,²⁴ the transfer of property from one trust to another under authority reserved in the original trust did not result in federal gift tax liability except, as the court noted, for transfers to a trust for other beneficiaries.²⁵

Generation skipping issues. In general, a modification of a trust arrangement that does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation²⁶ than the person or persons who held the beneficial interest before the modification, and the modification does not extend the time for the vesting of any beneficial interest beyond the period provided in the original trust, does not cause a trust that is exempt from generation skipping transfer to be subject to the tax.²⁷ As IRS has pointed out, a modification that is administrative in nature and that only indirectly increases the amount transferred (for example by

lowering income taxes or administrative costs) is not considered a shift in a beneficial interest in a trust.²⁸ Accordingly, the shift does not ordinarily, in such circumstances, change the inclusion ratio.

As for the question of whether a merger results in a constructive addition to a trust for generation skipping transfer tax purposes, the important issue is whether the trust or trusts were created (or added to) after September 25, 1985.²⁹

In conclusion

At some point, mergers and consolidations may pose problems of such magnitude that Congress will enact a comprehensive set of provisions to guide such transfers. Until that occurs, reliance will necessarily continue to be placed on rulings and cases.

Footnotes

¹ See I.R.C. § 368. See generally 8 Harl, *Agricultural Law* § 59.07[3] (2006); Harl, *Agricultural Law Manual* § 7.02[6][c][iii] (2006).

² See I.R.C. § 61, 1001.

³ See I.R.C. § 1015.

⁴ I.R.C. § 1223(2).

⁵ See I.R.C. § 2501.

⁶ I.R.C. §§ 2601, 2611(a).

⁷ I.R.C. § 2642.

⁸ See, e.g., Ltr. Rul. 200548018, Aug. 15, 2005.

⁹ Treas. Reg. § 1.1001-1(a).

¹⁰ *Cottage Savings Association v. Comm’r*, 499 U.S. 554 (1991).

¹¹ Ltr. Rul. 200544007, July 28, 2005.

¹² I.R.C. §§ 61, 1001. See Ltr. Rul. 200548018, Aug. 15, 2005.

¹³ Treas. Reg. § 1.671-2(e)(5).

¹⁴ Ltr. Rul. 9610021, Dec. 8, 1995. See also Ltr. Rul. 200607015, November 4, 2005 (no estate, gift, GSTT or income tax consequences; trust beneficiaries essentially the same as before proposed change).

¹⁵ I.R.C. § 1015(b).

¹⁶ *Id.*

¹⁷ Ltr. Rul. 200548018, Aug. 15, 2005; Ltr. Rul. 200544007, July 28, 2005 (no change of basis in merger of several trusts holding retirement plan funds).

¹⁸ I.R.C. § 1223(2). See Ltr. Rul. 200544007, July 28, 2005 (no change in holding period for assets in merger of several trusts holding retirement plan funds).

¹⁹ I.R.C. § 2512(b).

²⁰ Ltr. Rul. 200548018, Aug. 15, 2005.

²¹ Ltr. Rul. 9619047, Feb. 7, 1996.

²² *Id.*

²³ Ltr. Rul. 9509008, Nov. 29, 1994.

²⁴ *Lahti v. Comm’r*, 6 T.C. 7 (1946).

²⁵ *Id.*

²⁶ See I.R.C. § 2651.

²⁷ Ltr. Rul. 200548018, Aug. 15, 2005.

²⁸ *Id.*

²⁹ Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 1431, 1433, 100 Stat. 2717 (1986).