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Department of the Treasury
Washington, DC 20224

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Person To Contact:

Telephone Number:

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Date: DECEMBER 23, 2004

In Re:

LEGEND:

Grantor	=
Trust	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Year 1	=
a	=
b	=
State	=
State Statute	=
County Court	=
Community Trust	=

Dear :

This is in response to your June 29, 2004 letter and other correspondence requesting a ruling concerning the income and generation-skipping transfer tax (GST) consequences of a proposed reformation of Trust.

You have requested the following rulings:

1. The proposed reformation of Trust will not affect the exempt status of Trust for GST tax purposes.

2. The proposed reformation of Trust will not result in the recognition of gain or loss to Trust or any of Trust's beneficiaries.

The facts submitted are as follows:

Grantor established Trust on Date 1 (before January 1, 1970). Article I(a) and (b) of Trust provides, in part, that during the period of 60 years from the date of execution of Trust (the Charitable Term) the Trustee is to hold the entire Trust Estate as a separate trust solely and exclusively for charitable, scientific, and educational purposes. During the Charitable Term, the Trustee is to distribute, no less often than annually, the entire net income of the trust to or for the use of entities for which a deduction under section 2522(a) of the Internal Revenue Code would be allowable. Such distribution is to be made as directed in writing by Community Trust.

Article I(c) provides that at the end of the Charitable Term, the Trustee, at the direction of Community Trust, is to distribute all then accrued or undistributed income to or for charitable, scientific, or educational purposes or institutions. Nothing contained in Trust is to be construed to divert from such purposes or institutions any part of the net income of Trust for the entire Charitable Term.

Article II(a) provides that at the end of the Charitable Term, if the Trust Estate Distribution Date has not then occurred, the Trustee is to then divide the Trust Estate, exclusive of all then accrued or undistributed income, into separate trust funds of equal value, creating one fund for the primary benefit of each then living lawful descendant of Grantor.

Article II(b) provides, in part, that as long as the beneficiary for whose primary benefit a separate trust fund is created under this Article, the Trustee is to distribute the entire net income of the trust fund to the beneficiary. However, any portion of the net income in excess of the amount which the Trustee deems requisite for the education and reasonable comfort of the beneficiary, considering other funds available to the beneficiary, may either be accumulated and added to the principal of the trust fund or may be distributed to or for the benefit of any of Grantor’s lawful descendants, in such proportions as the Trustee deems requisite for the education and reasonable comfort and support of such individuals.

Article II(d) defines the Trust Estate Distribution Date as the later of: (i) 21 years after the death of the last survivor of Grantor and all of his lawful descendants living on Date 1, or (ii) the end of the Charitable Term, whichever event occurs later. If the end of the Charitable Term is the Trust Estate Distribution Date, then on the Trust Estate Distribution Date, the Trustee is to distribute the entire trust estate to Community Trust. If the end of the Chartable Term is not the Trust Estate Distribution Date, then on the Trust Estate Distribution Date, each trust fund held under Article II to the Grantor’s then living lawful descendants per capita.

The taxpayer represents that on Date 4 (approximately 39.5 years after Date 1), at least one of the Grantor’s lawful descendants who was living on Date 1, was still alive. Accordingly, the Trust Estate Distribution Date will not occur until after the end of the Charitable Term. Therefore, on the Trust Estate Distribution Date, the Trustee is to distribute each trust fund held under Article II to the Grantor's then living lawful descendants per capita.

Article VIII provides that Trust is governed by the law of State. Article IX provides that Grantor has no power to modify, alter, amend, or revoke Trust in any manner or any extent.

On Date 2, Trustee, Community Trust, and the descendants of Grantor entered into a settlement agreement. The agreement primarily resolves disputes among the parties related to grant-making procedures, fees and other current distributions.

Under Paragraph 9(a) of the settlement agreement, Trustee is to distribute each calendar year to Community Trust the greater of the net trust accounting income of Trust or an amount equal to the "applicable percentage" of the value of Trust determined as of December 31 of the prior year.

Exhibit I of the settlement agreement provides that the applicable percentage for Year 1 is a%. If the net value of Trust is equal to or greater than the "Target Benchmark" figure set forth in Column C of Table A (attached to the settlement agreement), then the applicable percentage for that year is to be the percentage set forth in Column B of Table A. If the net value of Trust is less than the Target Benchmark for that year, then the applicable percentage is to equal the previous year's applicable percentage. In no event does the applicable percentage decline in any year. In no event does the applicable percentage exceed b%.

On Date 3, County Court ordered that Trust be reformed in accordance with the settlement agreement.

LAW AND ANALYSIS

Ruling 1

Section 2601 imposes a tax on every generation-skipping transfer, which is defined under section 2611 as a taxable distribution, a taxable termination, and a direct skip.

Under section 1433(a) of the Tax Reform Act of 1986 and section 26.2601-1(a) of the Generation-Skipping Transfer Tax Regulations, the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under section 1433(b)(2)(A) of the Tax Reform Act and section 26.2601-1(b)(1)(i), the tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985, and no addition (actual or constructive) was made to the trust after that date.

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. In general, unless specifically noted otherwise, these rules are applicable only for purposes of determining whether an exempt trust retains exempt status for generation-skipping transfer tax purposes. 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 section 1001.

Section 26.2601-1(b)(4)(i)(D) provides that a modification will not cause an exempt trust to be subject to the GST tax if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 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. A modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a generation-skipping transfer or the creation of a new generation-skipping transfer.

Section 26.2601-1(b)(4)(E), Example 8, considers a situation where a trust that is otherwise exempt from the GST tax provides that trust income is payable to A for life and, upon A's death, the remainder is to pass to A's issue, per stirpes. In 2002, the appropriate local court approves a modification to the trust that converts A's income interest into the right to receive the greater of the entire income of the trust or a fixed percentage of the trust assets valued annually (unitrust interest) to be paid each year to A for life. The example concludes that the modification does not result in a shift in beneficial interest to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. Rather, the modification can only operate to increase the amount distributable to A and decrease the amount distributable to A's issue. In addition, 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. Therefore, the trust will not be subject to the provisions of chapter 13.

In this case, as in Example 8, the modification changing the method for determining the amount distributable to the charitable organizations can only operate to increase the amount distributable to those organizations and decrease the amount distributable to individual remainder beneficiaries and their issue. Further, the modification does not extend the time for vesting of any beneficial interest in Trust beyond the period provided for in the original Trust. Accordingly, based on the facts submitted and representations made, we conclude that the proposed reformation of Trust will not affect the exempt status of Trust for GST tax purposes.

Ruling 2

Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

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 section 1011 for determining gain, and the loss is the excess of the adjusted basis provided in section 1011 for determining loss over the amount realized. Under section 1001(c), the entire amount of gain or loss must be recognized, except as otherwise provided.

Section 1.1001-1(a) of the Income Tax Regulations provides that except as otherwise provided in subtitle A of the Code, 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 as loss sustained.

Rev. Rul. 56-437, 1956-2 C.B. 507, provides that 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.

Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991), provides that an exchange of property results in the realization of gain or loss under section1001 if the properties exchanged are materially different. Properties exchanged are materially different if the properties embody legal entitlements "different in kind or extent" or if the properties confer "different rights and powers." Id. at 565. In Cottage Savings, the Court held that mortgage loans made 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. Id. at 566. In defining what constitutes a "material difference" for purposes of section 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. Id. at 564-65.

State Statute authorizes a trustee to convert a trust to a “total return trust,” as defined in the statute, if certain requirements are satisfied. State Statute also provides, in part, that the trustee may for any reason elect to petition the court to order conversion to a “total return trust” as defined in the statute. Under the statute, the court has authority to order conversion to (or adjustment of the distribution percentage of) a total return trust if the court determines that the conversion (or adjustment of the distribution percentage) will enable the trustee to better carry out the purposes of the trust and the conversion (or adjustment of the distribution percentage) is in the best interests of the beneficiaries.

In the instant case, the conversion of the Trust in the manner described is authorized under State law. Trustee has authority, pursuant to State Statute, to convert Trust to a “total return trust,” as that term is defined in State Statute. The mere exercise of the trustee's authority is not a sale or other disposition under section 1001 of a trust interest by any beneficiary. Thus, neither gain nor loss is realized on the conversion. Accordingly, based on the facts submitted and representations made, we conclude that the proposed reformation of Trust will not result in the recognition of gain or loss under section 1001.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer’s authorized representatives.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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 material submitted in support of the request for rulings, it is subject to verification on examination.

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

Sincerely yours,

George L. Masnik
Branch Chief, Branch 4
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure:
Copy of letter for section 6110 purposes