Internal Revenue Service

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Re:

Legend:

Date 1	=
Date 2	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Trustor	=
A	=
Granddaughter	=
Trust	=
Separate Trusts	=
Trustee	=
Stock	=
Partnership	=
Court	=
State	=
State Statute 1	=
State Statute 2	=

$X =

Dear :

This is in response to a correspondence requesting a ruling regarding the generation-skipping transfer (GST) tax and gift tax consequences of proposed adjustments between income and principal by the trustee of four trusts in accordance with a state statute.

The facts submitted and representations made are as follows. Trustor created an irrevocable inter vivos trust (Trust) on Date 1, a date prior to September 25, 1985. Trust was created for the primary benefit of the Trustor's son and daughter and their descendants. Trust was funded with Stock. Situs of Trust is State. Trust was fully funded on Date 1, and you have represented that no additions have been made to Trust after September 25, 1985.

Paragraph First of Trust provides that Trustor's son and daughter would receive all the income in equal parts for life. At the later of the death of the Trustor or the attainment of age 56 by the son, the Trust would be divided into equal shares for the Trustor's son and daughter. Upon the division, son's share would be distributed outright to him and daughter's share would remain in trust with the income payable to the daughter for life. Upon daughter's death, all of the income of daughter's share of Trust would be payable equally to daughter's children for life. Upon the death of a child of daughter, the child's share would be held for the child's living issue and distributed to them, per stirpes, once each living issue attains a certain age (35 for each male issue and 30 for each female issue).

Paragraph Seventh of Trust provides that the trustee shall determine how all receipts and disbursements shall be credited, charged or apportioned as between principal and income, provided the trustee shall not charge against income of the trust estate any sums which as a matter of law are chargeable only against the principal of the trust estate.

Paragraph Thirteenth provides that unless terminated earlier pursuant to other provisions of Trust, Trust shall terminate immediately prior to the expiration of twenty-one years from and after the death of the last survivor of the Trustor and his now living wife and issue.

Daughter died and the income from her share of Trust was distributed to her two children, A and Granddaughter. A died and her share of Trust was distributed outright to her issue. On Date 2, pursuant to Court order, Granddaughter's share of Trust was divided into four separate equal trusts (Separate Trusts) for the benefit of Granddaughter's four children. A favorable ruling was received from the Internal Revenue Service providing that the Date 2 Court order dividing Granddaughter's share of Trust into four Separate Trusts did not affect the grandfathered status of the Separate Trusts for GST tax purposes.

In Year 1 Trust became a limited partner in Partnership. The investment in Partnership was divided equally among the Separate Trusts. Partnership was unprofitable and incurred substantial losses. It is represented that the Separate Trusts' interests and Partnership are now worthless. It is further represented that the losses were operating losses and were passed through to the Separate Trusts and ultimately to Granddaughter as items of ordinary loss rather than capitol loss. It is represented that, as a result, Granddaughter received the tax benefit of the losses because Granddaughter was able to offset such losses against her other income. At the time the losses were incurred, Trustee did not reduce income distributions to Granddaughter on account of the losses. It is represented that as a result of the tax treatment of the losses, Granddaughter received an economic benefit at the expense of the remainder beneficiaries because the economic loss from the investment reduced the principal of the Separate Trusts.

Trustee received authorization of Court to exercise its discretion to make an equitable adjustment with respect to the losses from Partnership by reducing the amount of income to be distributed to Granddaughter in Year 4 by $X, which is fifty-percent of the losses that have passed through to Granddaughter from Trust and subsequently from the Separate Trusts. The Court order provides that Trustee may make an equitable adjustment by making a proportionate reduction in the amount of income that would otherwise be paid to Granddaughter in Year 4 from each of Separate Trusts, so the total reduction from the Separate Trusts is $X. Such adjustment would be a final adjustment of the interests of Granddaughter and the remainder beneficiaries for the loss sustained by the investment in Partnership for Years 1, 2 and 3.

You have requested the following rulings:

1. The equitable adjustments between income and principal of the respective Separate Trusts made by the trustee in compliance with the Year 4 Court order will not affect the GST exempt status of Trust or the Separate Trusts.

2. The income beneficiary will not have made an addition to Separate Trusts for GST tax purposes or a gift for gift tax purposes as a result of the equitable adjustments between income and principal of Trust and the respective Separate Trusts made by the trustee in compliance with the Year 4 Court order.

ISSUES 1 & 2

Section 2501 of the Internal Revenue Code imposes a tax on the transfer of property by an individual.

Section 2511(a) provides that the gift tax shall apply 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 2601 imposes a tax on each generation-skipping transfer. Under section 1433(b)(2)(A) of the Tax Reform Act of 1986 Act and § 26.2601-1(b)(1)(I) of the Generation-Skipping Transfer Tax Regulations, the generation-skipping transfer tax shall not apply to any generation-skipping transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that the transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added).

Section 26.2601-1(b)(1)(ii)(A) provides that any trust in existence on September 25, 1985, will be considered an irrevocable trust except as provided in § 26.2601-1(b)(1)(ii)(B) or (C) (relating to property includible in the grantor's gross estate under §§ 2038 and 2042).

Section 26.2601-1(b)(1)(iv) provides that if an addition is made after September 25, 1985, to an irrevocable trust which is excluded from chapter 13 by reason of paragraph (b)(1) of this section, a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the provisions of chapter 13.

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 generation-skipping transfer tax will not cause the trust to lose its exempt status. The regulation provides that the rules contained in the paragraph are applicable only for purposes of determining whether an exempt trust retains its 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 § 1001.

Section 26.2601-1(b)(4)(i)(D) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, but only if –

> (1) The modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and

(2) 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.

Section 26.2601-1(b)(4)(i)(E) Example 12, provides that in 1980, Grantor, a resident of State X, established an irrevocable trust for the benefit of Grantor's child, A, and A's issue. The trust 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 State X amends its income and principal statute to permit the trustee to make adjustments between income and principal when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that shall or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding allocation of receipts between income and principal is unable to administer the trust impartially. The provision permitting the trustees to make these adjustments is effective in 2002 for trusts created at any time. The trustee invests and manages the trust assets under the state's prudent investor standard, and pursuant to authorization in the state statute, the trustee allocates receipts between the income and principal accounts in a manner to ensure the impartial administration of the trust. The administration of the trust in accordance with the state statute will not be considered to shift any beneficial interest in trust. Therefore, the trust will not be subject to the provisions of chapter 13. Further, under the facts, no trust beneficiary will be treated as having made a gift for federal gift tax purposes and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes.

State Statute 1 grants trustees authority to allocate proceeds and losses of a trade or business between principal and income in accordance with what is reasonable and equitable to the interests of the income beneficiaries and the principal beneficiaries.

State Statute 2 provides that a trust shall be administered with due regard to the respective interests of income beneficiaries and remaindermen. A trust is so administered with respect to the allocation of receipts and expenditures if a receipt is credited or an expenditure is charged to income or principal or partly to each:

(1) In accordance with the terms of the trust instrument, notwithstanding contrary provisions of this chapter;

(2) In the absence of any contrary terms of the trust instrument, in accordance with this chapter; or

(3) If neither of the preceding rules of administration is applicable, in accordance with what is reasonable and equitable in view of the interests of those entitled to income as well as of those entitled to principal, and in view of the manner in which men of

ordinary prudence, discretion and judgment would act in the management of their own affairs.

Based on the facts presented and representations made, we conclude that the equitable adjustments between income and principal of the respective Separate Trusts made by the trustee in compliance with the Year 4 Court order will not shift any beneficial interest in the Separate Trusts to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the adjustments and will not extend the time for vesting of any beneficial interest in the Separate Trusts beyond the period provided for in Trust. Accordingly, based on the facts submitted and the representations made, if Trustee of the Separate Trusts makes the equitable adjustments between income and principal of the respective Separate Trusts in compliance with the Year 4 Court order, such adjustments will not affect the GST exempt status of the Separate Trusts. Further, the income beneficiary will not have made an addition to the Separate Trusts for GST purposes or made a taxable gift as a result of the equitable adjustments between income and principal of Trust and the respective Separate Trusts made by the trustee in compliance with the Year 4 Court order.

Section 26.2601-1(b)(4)(ii) provides that the rule in Example 12, regarding the administration of a trust and the determination of income in conformance with applicable state law, applies to trusts for taxable years ending after January 2, 2004. Year 4 is prior to January 2, 2004. However, taxpayers may rely on the provisions of the final regulation for any taxable year in which a trust is governed by a state statute granting the trustee a power to adjust between income and principal. See 69 Fed. Reg. No.1 12, 17 (June 2, 2004).

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.

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 yours,

Lorraine E. Gardner
Senior Counsel, Branch 4
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure
Copy for section 6110 purposes

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