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Department of the Treasury
Washington, DC 20224

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Date:
December 09, 2005

Trust 1 =

Trust 2 =

Decedent =

A =

B =

Foundation =

Bank =

State =

D1 =

D2 =

Year 1 =

Dear :

This letter responds to a letter dated February 9, 2005, and subsequent correspondence, submitted on behalf of Trust 1 and Trust 2 (collectively, the Trusts) by their authorized representative, requesting certain rulings under the Internal Revenue Code.

The information submitted states that the Trusts were established under the will of Decedent. Decedent died on D1 and the Trusts were funded in Year 1, which was before May 27, 1969. At the present time, Bank is serving as the sole trustee of the Trusts. The trustee of the Trusts represent that no additions, actual or constructive, have been made to the Trusts.

The terms of the Trusts are identical, except that A is the named beneficiary of Trust 1 and B is the named beneficiary of Trust 2. The terms of each trust provide that the income of each trust is to be paid to the named beneficiary during that beneficiary's lifetime and, thereafter, to that beneficiary's issue, collectively and in equal shares. If any issue of a beneficiary dies survived by issue, such surviving issue shall take, collectively and in equal shares, what such deceased issue would have taken, if living. There is no trust provision for the invasion of principal for the benefit of the income beneficiaries. If a beneficiary has no issue, or upon the death of the last survivor of a beneficiary's issue, the trust created for that beneficiary and that beneficiary's issue shall terminate, and the principal of the trust shall be distributed to Foundation, a § 501(c)(3) organization. If not terminated earlier due to the death of the named beneficiary and that beneficiary's issue, each trust will terminate 21 years after the death of the last survivor of such issue who survive Decedent.

At the time of Decedent's death, Decedent was a resident of State, and the Trusts are governed by the laws of State. The State probate code provides that for fiduciary accounting standards, gains and losses on disposition of property shall be netted and reported with receipts of principal.

Since Year 1, the trustees have allocated all capital gains earned by the Trusts to the principal of the Trusts and have never distributed capital gains to any of the income beneficiaries. For certain tax years of the Trusts, the trustees claimed charitable deductions under § 642(c)(2) for the capital gains as amounts permanently set aside for charitable purposes. For these years, the Internal Revenue Service determined that the Trusts are not entitled to the deduction under § 642(c)(2), based upon the provisions of Article Ninth of the Decedent's will, which provided the trustee certain powers regarding the determination and allocation of the Trusts' income and principal.

Rev. Rul. 73-95, 1973-1 C.B. 322, holds that if a trustee has discretionary power to allocate gains from the sale or other disposition of property constituting principal either to principal or to income, any amount the trustee elects to set aside will not qualify for a deduction under § 642(c)(2) since it has not been permanently set aside for a charitable purpose. In order to comply with Rev. Rul. 73-95, the trustee filed a petition with the State Probate Court (the Court) to modify the provisions of Article Ninth of Decedent's will. The petition was granted by the Court on D2.

Article Ninth, as modified by the petition, provides that the trustee has the power to take possession, control, and management of the trust estate; to collect and receive all income, interest, dividends, rents, and profits arising from and out of said trust estate; to allocate expenses, including a reasonable compensation to the trustees, in accordance with State accounting rules and State law, with income and principal shares bearing consistent, reasonable, and appropriate burdens of such expenses (Article Ninth, section (f)). The trustee has the power to decide what is income and what is principal in accordance with State probate accounting rules and State law, provided that all capital gains shall be assigned to principal and shall not be assigned to income (Article Ninth, section (s)). Article Ninth, as modified, further provides, that all determinations of the trustees in respect to each and all of the matters in Article Ninth shall be made in a manner consistent with permanent preservations of principal for the charitable remainder beneficiary and the charitable set-aside provisions of § 642(c) and shall be binding on all beneficiaries of the Trusts and all other persons having any right, title, or interest in or to the income or principal of the trust estate, whether present, future, vested, or contingent, and the trustees shall be under no liability with respect to any such determinations or to the effect or consequence thereof, nor shall their accounting as trustees be in any manner questioned, altered, surcharged, or affected with respect thereto; any trustee allocation of capital gains or other items of principal that is inconsistent with permanently setting principal aside for purposes enumerated in § 642(c)(2) shall be null and void. Certain other conforming changes and deletions were also made to Article Ninth.

Prior to the Court granting the petition, Article Ninth, section (s), provided that the trustee has the right to decide what is income and what is principal.

RULING 1

Section 642(c)(2)(A)(i) provides that in the case of a trust (other than a trust meeting the specifications of subpart B of part I of subchapter J) required by the terms of its governing instrument to set aside amounts which was created on or before October 9, 1969, if an irrevocable remainder interest is transferred to or for the use of an organization described in § 170(c), there shall be allowed as a deduction in computing its taxable income any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, permanently set aside for a purpose specified in § 170(c), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance, or operation of a public cemetery not operated for profit. In the case of a trust, the preceding sentence shall apply only to gross income earned with respect to amounts transferred to the trust before October 9, 1969, or transferred under a will to which § 642(c)(2)(B) applies.

Section 1.642(c)-2(b)(1) of the Income Tax Regulations describes, in general, the circumstances under which a trust will qualify for the set-aside deduction under § 642(c)(2). Section 1.642(c)-2(d) provides that no amount will be considered to be permanently set aside, or to be used, for a purpose described in § 1.642(c)-2(b)(1) unless under the terms of the governing instrument and the circumstances of the particular case the possibility that the amount set aside, or to be used, will not be devoted to such purpose or use is so remote as to be negligible.

Based solely on the facts and representations submitted, we conclude that the Trusts, as modified by the petition granted by the Court on D2, will be entitled to claim the deduction under § 642(c)(2) for amounts of gross income consisting of capital gains realized after D2 that are permanently set aside during a taxable year and added to trust principal for the ultimate benefit of Foundation.

RULING 2

Section 61 of the Code provides that gross income means all income from whatever source derived. 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 shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section 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 the property (other than money) received.

Section 1001(c) provides that, except as otherwise provided in subtitle A, the entire amount of the gain or loss, determined under § 1001, on the sale or exchange of property shall be recognized.

Section 1.1001-1(a) provides that the gain or loss realized from the conversion of property into cash, or 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. 69-486, 1969-2 C.B. 159, involves two beneficiaries of a trust who by mutual agreement, requested that the trustee distribute all of the trust corpus consisting of notes to one of the beneficiaries and all of the trust corpus consisting of common stock to the other beneficiary. The trust instrument as well as local law was silent regarding whether the trustee had the authority to make such a non-pro rata distribution of property in kind. Because the trustee was not specifically authorized to make an allocation of specific property in kind, the beneficiaries were treated as having an absolute right to a ratable in-kind distribution. Rev. Rul. 69-486 treats the beneficiaries as receiving the notes and common stock pro rata, followed by an exchange between the beneficiaries giving all of the common stock to one and all of the notes to the other. Since, in substance, an exchange between the beneficiaries was deemed to occur, Rev. Rul. 69-486 holds that the beneficiaries recognized gain under §§ 1001 and 1002.

The present case is distinguishable from Rev. Rul. 69-486 because Decedent's will gives the trustee broad authority regarding allocation and distribution of trust principal and income.

An exchange of property results in the realization of gain or loss under § 1001 if the properties are materially different. Cottage Savings Assoc. v. Commissioner, 499 U.S. 554 (1991). 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 Supreme Court held that mortgage loans made to different obligors and secured by different homes embodies distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans. Id. In defining what constitutes a "material difference" for purposes of § 1001(a), the Court states 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.

In the present case, the petition modifies the Trusts to expressly require the trustee to set aside capital gains permanently for Foundation and to expressly prohibit the trustee from disbursing capital gains or other forms of principal to the income beneficiaries. The trustee of the Trusts has represented that the modification to the Trusts is consistent with the intent of the Decedent to preserve the principal of the Trusts for the ultimate benefit of Foundation. As the Court has determined that this is the case and approved the modification as a way to meet the original intentions of Decedent, this will not result in a sale, exchange or disposition for purposes of § 1001 because the modification was a clarification of the original intention of Decedent.

Moreover, there will be no sale or exchange because the income beneficiaries did not obtain any additional rights or consideration in return for relinquishing their right to receive trust principal. Cf. Helvering v. Flaccus Oak Leather, 313 U.S. 247 (1941) (holding that without the reciprocal transfer of property, there can be no exchange under § 1001). In addition, according to the trustee of the Trusts, the trustee has always interpreted the trust language to require that capital gains be assigned to principal and to prohibit the distribution of capital gains to the income beneficiaries. Modifying the Trusts to conform to the trustee's long-standing practice will ensure that the beneficiaries will be entitled to the same benefits as those they received before the modification. Thus, the modification will not result in a material difference in legal entitlements for the income beneficiaries or Foundation.

Therefore, we conclude that the modification will not constitute a sale, exchange or disposition. Because there will be no sale, exchange or other disposition of property, the amendments to the Trusts will not result in a realization event to the income beneficiaries or the Trusts for purposes of § 1001. Thus, the modification to the Trusts will not trigger the recognition of gain under § 1001.

RULING 3

Section 2601 imposes a tax on every generation-skipping transfer (GST). Under § 1433(a) of the Tax Reform Act of 1986 (Act), the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to any generation-skipping transfer from a trust if the trust was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date. Under § 26.2601-1(b)(1)(ii), any trust in existence on September 25, 1985, will be considered irrevocable unless the settlor had a power that would have caused inclusion of the trust in his or her gross estate under § 2038 or § 2042, if the settlor had died on September 25, 1985.

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. The regulation provides that the rules are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes and do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, 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 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 § 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 GST transfer or the creation of a new GST transfer.

Section 26.2601-1(b)(4)(i)(E), Example 9, considers a situation in which, in 1980, Grantor established an irrevocable trust under the terms of which trust income is payable to Grantor's child, A, for life, and upon A's death, the remainder is to pass to A's issue, per stirpes. Under applicable state law, unless the governing instrument provides otherwise, capital gain is allocated to principal. In 2002, the trust is modified to allow the trustee to allocate capital gain to income. The modification does not shift any beneficial interest in the trust to a lower generation (as defined in § 2651) than the person or person who held the beneficial interest prior to the modification. The modification can only have the effect of increasing the amount distributable to A and decreasing 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 modification will not cause the trust to be subject to the GST tax.

In the present case, the Trusts were irrevocable on September 25, 1985. It is represented that no additions, actual or constructive, were made to the trusts after September 25, 1985. The governing provisions of the Trusts require the trustee to preserve the principal of the Trusts for the ultimate benefit of the charitable beneficiary but do not specifically reference the setting aside of capital gains for that purpose. Consistent with trust accounting principles in State, the trustee has always interpreted the trust language to require that all capital gains be allocated to principal. As a result, since Year 1, the trustee has always allocated capital gain to principal. The modification does not give the trustee additional power that the trustee does not currently have with respect to the Trusts. The modifications will not shift a beneficial interest in the trusts to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification. All other trust provisions remain the same, and the modifications do not extend the time for vesting of any beneficial interest beyond the period provided for in the original trusts.

Accordingly, based on the facts submitted and the representations made, we conclude that the modifications of the governing provisions of the Trusts will not adversely affect the Trusts' status as exempt from the GST tax, and the Trusts will continue to be exempt from the GST tax.

RULING 4

Section 4941(a), in part, imposes a tax on each act of self-dealing between a private foundation and a disqualified person. The tax is imposed on the disqualified person and, in certain situations, a tax is also imposed on the foundation manager(s) participating in the act or acts.

Section 4947(a)(2) provides that split-interest trusts are subject to the rules governing private foundations and, in particular, §§ 4941 through 4945.

Section 4947(a)(2)(C) states that split-interest trusts are exempt from the rules governing private foundations for any amounts transferred in trust before May 27, 1969.

The Trusts were funded in Year 1. The Trust are split-interest trusts as described in § 4947(a)(2). As such, the Trusts are subject to the § 4941 rules involving self-dealing. However, § 4947(a)(2) exempts any amounts transferred in trust before May 27, 1969, from the rules governing private foundations. Therefore, because the Trusts were funded in Year 1, there can be no self-dealing because § 4941 does not apply. Therefore, the amendment to Trust 1 and Trust 2 does not constitute self-dealing under § 4941.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code.

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.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to the Trusts' authorized representatives.

Sincerely,

J. THOMAS HINES
Chief, Branch 2
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures: 2
Copy of this letter
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