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Person To Contact:
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Telephone Number:

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Date: MARCH 10, 2010

RE:

Legend

Decedent =
Trust =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Child 1 =
Child 2 =
Grandchild 1 =
Grandchild 2 =
Grandchild 3 =
State =
Citation =
Court =

Statute =
x =

Dear :

This responds to your letter dated August 19, 2009, and subsequent correspondence, requesting rulings regarding the income, gift, and generation-skipping transfer (GST) tax consequences of a proposed modification of Trust.

The facts submitted and the representations made are as follows. Decedent died testate on Date 1, survived by his two children, Child 1 and Child 2. On Date 2, Decedent executed a Will and amended it in a codicil on Date 3. Section 4 of Article V of the Will establishes Trust.

Section 4 of Article V provides that the trustees shall pay out or distribute one-half of the net income of Trust to Child 1, for his life, and the remaining one-half to Child 2, for her life. After the death of Child 1, his one-half net trust income interest shall be paid out and distributed among his descendants, per stirpes. After the death of Child 2, her one-half net income interest shall be paid out and distributed among her descendants, per stirpes. Trust shall terminate 20 years after the death of the last survivor of Decedent's descendants living on the date of Decedent's death, at which time the trustees shall distribute the entire remaining trust property as then constituted to the beneficiaries at that time of the current income in the same proportion in which they are then entitled to receive such income.

Child 1 died on Date 4 survived by three children, Grandchild 1, Grandchild 2, and Grandchild 3. According to the terms of Trust, Child 1's one-half interest of Trust's net income has been paid in equal shares to Grandchild 1, Grandchild 2, and Grandchild 3. Child 2's one-half interest of Trust's net income has continued to be paid to Child 2. The current trustees of Trust are Grandchild 1 and Child 2, both of whom are current income beneficiaries of Trust. Trust is governed by State law and the income required to be distributed to the income beneficiaries of Trust is defined under the State Principal and Income Act (Citation).

The trustees of Trust propose to petition Court to convert Trust from an income-only trust to a total return trust (i.e., unitrust) in accordance with Statute. Statute provides that following the conversion of a trust to a total return trust, "income" in the governing instrument means an annual amount equal to a percentage (the "distribution percentage") of the fair market value of the trust's assets averaged over a three-year period. Under Statute, the distribution percentage must be fixed and cannot be less than 3 percent. Therefore, the trustees will petition Court to modify Trust to provide that Trust will distribute annual income equal to a fixed distribution percentage of x percent of Trust assets averaged over the three preceding years.

It has been represented that no additions have been made to Trust since Decedent's death, which was prior to September 25, 1985.

The trustees request the following rulings:

1. The proposed conversion of Trust to a Total Return Trust under State law will not cause Trust to lose its generation-skipping exempt status as a trust that was created and irrevocable on or before September 25, 1985.

2. The proposed conversion of Trust to a Total Return Trust under State law will not cause any beneficiary, or any trustee who is also a beneficiary, to have made a transfer, direct or indirect, of property for gift tax purposes.

3. The proposed conversion of Trust to a Total Return Trust under State law will not be considered a sale, exchange, or other disposition of property and will not cause Trust or any of the beneficiaries to realize gain or loss.

Rulings 1 and 2

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

Section 2511 provides that the tax imposed by § 2501 applies 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 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.

Section 2601 imposes a tax on every generation-skipping transfer. Section 2611(a) defines the term “generation-skipping transfer” as a taxable distribution, a taxable termination, and a direct skip.

Under § 1433(b)(2)(A) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the generation-skipping transfer tax provisions do not apply to any generation-skipping transfer under a trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985. However, this exemption does not apply if additions (actual or constructive) are made to the trust after September 25, 1985.

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

Section 26.2601-1(b)(4) 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 under § 26.2601-1(b)(1), (2), or (3) (hereinafter referred to as an exempt trust) will not cause the trust to lose its exempt status. In general, unless specifically provided otherwise, the rules contained in § 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. Unless specifically noted, 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 gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(D)(1) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy § 26.2601-1(b)(4)(i)(A), (B), or (C)) 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, 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.

Section 26.2601-1(b)(4)(i)(D)(2) provides that for purposes of this section, 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. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust 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 modification. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust. In addition, administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)-1 of the Income Tax Regulations.

Section 26.2601-1(b)(4)(i)(E), Example 11, considers a situation where a trust that is otherwise exempt from the GST tax because it was irrevocable prior to September 25, 1985, 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. State X, the situs of the trust, then amends its income and principal statute to define income as a unitrust amount of 4 percent of the fair market value of the trust assets valued annually. The example concludes that the administration of the trust, in accordance with the state statute defining income to be a 4 percent unitrust amount will not be considered to shift a beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13. Further, under the facts of the example, 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.

The trustees represent that Trust was irrevocable on September 25, 1985 and that there were no additions to Trust after September 25, 1985.

The facts in this case are similar to those set forth in Example 11 of § 26.2601-1(b)(4)(i)(E), which concludes that the proposed conversion of a trust to a total return trust under state law will not cause the trust to lose its GST exempt status and that no trust beneficiary will be treated as having made a gift for federal gift tax purposes.

Provided the proposed conversion meets the requirements of State Statute and Court issues an order approving the conversion, we conclude that the conversion of the income interest in Trust to a unitrust interest will not be considered to shift any beneficial interest in Trust and, therefore, will not cause Trust to lose its generation-skipping exempt status as a trust that was created and irrevocable on or before September 25, 1985. We further conclude that the proposed conversion of Trust to a Total Return Trust under State Law will not cause any beneficiary, or any trustee who is also a beneficiary, to have made a transfer, direct or indirect, of property for gift tax purposes.

Ruling 3

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 § 1011 for determining loss over the amount realized. Under § 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.

An exchange of property results in the realization of gain or loss under § 1001 if the properties exchanged are materially different. Cottage Savings Ass'n 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 Court held that mortgage loans made to different obligors and secured by different homes did embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interest in the loans. Id. at 566. In defining what constitutes a "material difference" for purposes of § 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.

Section 1.643(b)-1 provides a comprehensive definition of "income" as that term applies to trusts and estates. It provides, in part, that items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal. However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3 percent and no more than 5 percent of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. Section 1.643(b)-1 further provides that a switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of § 1001. A switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of § 1001.

Thus, § 1.643(b)-1 recognizes that the conversion of an income trust to a total return trust or unitrust where the unitrust amount is no less than 3 percent and no more than 5 percent of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Further, such conversions authorized under a governing state statute are considered nonrecognition events for purposes of § 1001. Therefore, in the instant case, a change in the terms of Trust from distributions of income only to distributions of an unitrust amount of x percent of the fair market value of Trust assets determined on a multiple year basis is consistent with applicable State law and, therefore, pursuant to § 1.643(b)-1, does not constitute a recognition event for purposes of § 1001.

Assuming Court approves the proposed conversion of Trust to a Total Return Trust under the terms and conditions of the petition, we conclude that the conversion will not be considered a sale, exchange, or other disposition of property and will not cause Trust or any beneficiaries to realize gain or loss under § 1001.

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 ruling(s) in this letter pertaining to the federal estate and/or generation-

skipping transfer tax apply only to the extent that the relevant sections of the Internal Revenue Code are in effect during the period at issue.

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 your authorized representative.

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.

Sincerely,

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

Enclosures (2)