Internal Revenue Service

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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
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Date:
August 01, 2011

Re:

Husband =
Spouse =
Date 1 =
Date 2 =
Year =
Trust =

Trustees =

Children =
a =
b =
c =
d =
e =
State =
Statute
State =

Dear :

This letter responds to a letter from your authorized representative, dated January 26, 2011, requesting estate and generation-skipping transfer (GST) tax rulings with respect to the proposed modification of a trust.

FACTS

You represent the facts to be as follows:

Husband created a revocable trust, Trust, on Date 1, and amended Trust on Date 2. Husband died in Year, survived by Spouse and Husband's children from a prior marriage, Children. Date 1 is subsequent to September 25, 1985.

Pursuant to Article III of Trust, following Husband's death, Trust's assets were to be divided into a marital trust, Marital Trust, and a family trust. The family trust is not the subject of any ruling request herein. Pursuant to Article III, Paragraph C of Trust, the Trustees shall, from time to time but not less often than quarter annually, pay the net income from Marital Trust to Spouse or apply the net income for Spouse's benefit. Paragraph C further provides that the Trustees may, in their sole discretion, pay to or expend for Spouse's benefit so much of the principal of Marital Trust as Trustees deem advisable for the health, support, comfort, welfare or other needs of Spouse.

On Husband's Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, the personal representative of Husband's estate made a § 2056(a)(7) election to treat the assets held in Marital Trust as qualified terminable interest property (QTIP). The personal representative also allocated Husband's available GST exemption to Marital Trust. Marital Trust was divided into two separate trusts, one trust with an inclusion ratio of zero for GST purposes, Marital GST Exempt Trust, and one trust with an inclusion ratio of 1 for GST purposes. Marital Trust is administered under the laws of State.

Spouse and Children request that the Trustees modify Marital Trust by converting Marital Trust to a total return unitrust as follows:

(1) For purposes of the unitrust, the fair market value of Marital Trust assets shall be determined as of close of business on the last business day of the taxable year of Marital Trust immediately before the then current taxable year of Marital Trust (the "Valuation Date"). All assets of Marital Trust are included for purposes of determining the fair market value of Marital Trust assets.
(2) The unitrust percentage applicable in a given year will be based on the total value of the Marital Trust assets as of the Valuation Date. As the total value of the assets reaches certain predetermined benchmarks, the applicable unitrust percentage is as follows:
    a. If the total value of Marital Trust assets is less than $a million on the Valuation Date, the unitrust percentage for the taxable year will be 4.15%;

b. If the total value of Marital Trust assets is $a million or more but less than $b million on the Valuation Date, the unitrust percentage for the taxable year will be 4%;
c. If the total value of Marital Trust assets is $b million or more but less than $c on the Valuation Date, the unitrust percentage for the taxable year will be 3.8%;
d. If the total value of Marital Trust assets is $c million or more but less than $d million on the Valuation Date, the unitrust percentage for the taxable year will be 3.575%;
e. If the total value of Marital Trust assets is $d million or more but less than $e million on the Valuation Date, the unitrust percentage for the taxable year will be 3.3%; and
f. If the total value of Marital Trust assets is $e million or more on the Valuation Date, the unitrust percentage for the taxable year will be 3%.

As discussed further below, under certain conditions State Statute permits a trustee to convert a trust to a total return unitrust. Trustees adopted a written policy for the proposed conversion of Marital Trust to a total return unitrust pending receipt of a favorable private letter ruling from the Internal Revenue Service. You represent that Trustees complied with all requirements as set forth in State Statute to convert Marital Trust to a total return unitrust.

You request the following rulings:

1. The proposed conversion to a unitrust as outlined above will not affect the GST tax inclusion ratio of Marital GST Exempt Trust.
2. The proposed conversion to a unitrust as outlined above will not affect the qualification of Marital Trust for the marital deduction.

LAW AND ANALYSIS

Ruling Request No. 1

Section 2601 imposes a tax on every generation-skipping transfer made after October 26, 1986.

Under § 1433(a) of the Tax Reform Act of 1986 (Act) and § 26.2601-1(a) of the Generation-Skipping Transfer Tax Regulations, the GST tax is generally applicable to GSTs made after October 22, 1986. However, under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i), the GST tax does not apply to a 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). Under § 26.2601-1(b)(1)(ii), any trust in existence on September 25, 1985, will be considered irrevocable unless the decedent had a power

that would have caused inclusion of the trust in his or her gross estate under § 2038 or § 2042, if the decedent 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 under § 26.2601-1(b)(1), (2), or (3) will not cause the trust to lose its exempt status. Under the regulation, unless specifically provided otherwise, these rules are applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. Thus (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 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 1.643(b)-1 provides, in part, that 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% and no more than 5% 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.

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, amends its income and principal statute to define income as a unitrust amount of 4% 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% unitrust amount will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13. Further, the example states that, under these 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 provides that, under certain conditions, a trustee may, in its sole discretion and without judicial approval, (i) convert an income trust to a total return unitrust, (ii) convert a total return unitrust to an income trust, or (iii) change the percentage used to calculate the unitrust amount or the method used to determine fair market value of the trust. State Statute further provides that the percentage used to calculate the unitrust amount shall be no less than 3% nor more than 5%.

In the instant case, Marital Trust became irrevocable after September 25, 1985, and it is represented that sufficient GST exemption was allocated to Marital GST Exempt Trust such that Marital GST Exempt Trust has an inclusion ratio of zero under § 2642. No guidance has been issued concerning modifications that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption was allocated to the trusts to result in an inclusion ratio of zero. At a minimum, a modification that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of such a trust.

Under the proposed modifications, Trustees propose to administer Marital Trust pursuant to State Statute which meets the requirements of § 1.643(b)-1 and § 26.2601-1(b)(4)(i)(D). Therefore, the conversion and administration of Marital Trust pursuant to State Statute, as described above, does not shift a beneficial interest in

Marital Trust or 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 Marital Trust beyond the period provided for in the original trust. See § 26.2601-4(b)(4)(i)(E), Example 11. Accordingly, we conclude that the conversion and administration of Marital Trust pursuant to State Statute will not affect the GST tax inclusion ratio of Marital GST Exempt Trust.

Ruling Request No. 2

Section 2056(a) provides that for purposes of the tax imposed by § 2001, the value of the taxable estate shall, except as limited by § 2056(b), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

Section 2056(b)(1) provides that where on the lapse of time, on the occurrence of an event or contingency, or the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, no deduction is allowed with respect to such interest (A) if an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse), and (B) if by reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse.

Section 2056(b)(7) allows an estate tax marital deduction for qualified terminable interest property. Under § 2056(b)(7)(B)(i), the term "qualified terminable interest property" means property which passes from the decedent, in which the surviving spouse has a qualifying income interest for life, and to which the QTIP election under § 2056(b)(7)(B)(v) applies. Section 2056(b)(7)(B)(ii) provides that the surviving spouse has a qualifying income interest for life if the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, and no person has a power to appoint any part of the property to any person other than the surviving spouse during the surviving spouse's life.

Section 20.2056(b)-7(d)(2) of the Estate Tax Regulations provides that the principles of § 20.2056(b)-5(f), relating to whether the spouse is entitled for life to all of the income from the entire interest or a specific portion of the entire interest, apply in determining whether the surviving spouse is entitled for life to all of the income from the property regardless of whether the interest passing to the spouse is in trust.

Section 20.2056(b)-5(f)(1) provides that if an interest is transferred in trust, the surviving spouse is entitled to all of the income from the entire interest or a specific portion of the entire trust if the effect of the trust is to give her substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust. In addition, the surviving spouse shall be entitled for life to all of the income from the entire interest or a specific portion of the entire interest if the spouse is entitled to income as determined by applicable local law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of §1.643(b)-1.

As discussed above, we have concluded that State Statute meets the requirements of § 1.643(b)-1. You represent that a timely QTIP election was made on Husband's Form 706 with respect to Marital Trust. Accordingly, we conclude that the proposed conversion and administration of Marital Trust pursuant to State Statute will not affect the qualification of Marital Trust for the marital deduction.

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.

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 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 representatives.

Sincerely,

James F. Hogan
Branch Chief, Branch 4
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosure
Copy for §6110 purposes