

Internal Revenue Service

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:4 - PLR-132577-01
Date:

Re:

May 06, 2002

LEGEND:

- Decedent -
- Grandson -
- Trust -
- Charity 1 -
- Charity 2 -
- Charity 3 -
- Charity 4 -
- Corporation -
- Date 1 -
- Year 1 -
- S dollars -
- X dollars -
- Y dollars -
- Z dollars -

Dear :

This is in response to the June 12, 2001 letter and other correspondence from your authorized representative requesting rulings concerning the generation-skipping transfer tax, income tax and gift tax consequences of the proposed modification of the Trust.

The facts submitted are as follows:

Decedent died testate on Date 1, prior to 1985. Pursuant to the terms of Decedent's will, a residuary testamentary trust (Trust), was established primarily for the benefit of Decedent's grandson (Grandson). Under the terms of Trust, Grandson was to receive S dollars each year during his life. Upon Grandson's death, the corpus was to be distributed as follows: 1/3 to Charity 1; 1/3 to Charity 2; 1/6 to Charity 3; and 1/6 to Charity 4. The terms of Trust provide that no beneficiary could alienate or encumber his/her interest in the income or principal and no beneficiary's interest was subject to claims of his/her creditors prior to distribution. Trust was funded with stock of Corporation with an approximate value of X dollars.

In Year 1, pursuant to a court order, the investments of Trust were restructured and the dispositive provisions of Trust were modified to provide for annual income distributions to Grandson in accordance with a Performance Chart. The order required distributions to Grandson of an amount equal to the lesser of the maximum income amount set forth in the Performance Chart or the actual net income of Trust. Grandson was guaranteed a minimum income amount even if actual Trust income was less than that minimum income amount. Thus, if earnings of Trust are sufficient, Grandson would receive more than the minimum stated

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amounts each accounting period. In addition, Charities 1, 2, 3 and 4 received a lump sum payment. Upon Grandson's death, the remaining corpus was to be distributed to the Charity 1, Charity 2, Charity 3, and Charity 4 (or their successors) in the same proportion as set forth in Trust.

Subsequently, disputes arose regarding the continuing administration of Trust. The parties have entered into an agreement to resolve the dispute. The agreement will be submitted to the appropriate court for approval. Under the terms of the proposed agreement, corpus of Trust in excess of Z dollars will be distributed immediately to Charity 1, Charity 2, Charity 3, and Charity 4 (or their successors) in the same proportion of their current remainder interests in Trust. Upon distribution, the charities' interest in Trust will terminate. The remaining assets of Trust will continue in trust for the benefit of Grandson. Grandson will receive at least annually an amount equal to seven percent of the net fair market value of the property held in Trust determined on a specified date in each calendar year. In addition, the trustee may distribute income or principal to provide adequately for the reasonable support of Grandson. On Grandson's death, the remaining corpus will be distributed pursuant to Grandson's exercise of a testamentary general power to appoint the remaining corpus to anyone, including his estate or the creditors of his estate. Any portion of the Trust not effectively appointed by the exercise this power will be distributed to Grandson's surviving descendants free of trust.

Rulings requested

You have requested the following rulings:

- (1) The implementation of the terms of the proposed agreement and court order will not result in the realization of capital gain, capital loss or taxable income by any party to the order.
- (2) The implementation of the proposed agreement and court order will not result in a taxable gift by any party to the order of either a present or future interest in property during the administration of the trust or as a result of Grandson's death.
- (3) The implementation of the proposed agreement and court order will not result in Trust losing its status as exempt from generation-skipping transfer (GST) tax.

Ruling Request #1: Income Tax

Section 61(a)(3) of the Internal Revenue Code 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 will be the excess of the amount realized from the sale over the adjusted basis provided in § 1011 for determining gain, and the loss will 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 any property received. Section 1001(c) provides that the entire amount of the gain or loss, determined under

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§ 1001, on the sale or exchange of property shall be recognized.

Section 1001(e)(1) provides that in determining gain or loss from the sale or disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to §§ 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded. Under § 1001(e)(2), a "term interest in property" includes an income interest in a trust. Section 1001(e)(3) provides that the general rule of § 1001(e)(1) does not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons.

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 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.

Section 1.1001-1(f)(1) provides that for purposes of determining the gain or loss from the sale or other disposition of a term interest in property, a taxpayer shall not take into account that portion of the adjusted basis of such interest, which is determined pursuant to § 1014 of the Code, to the extent that such adjusted basis is a portion of the adjusted uniform basis of the entire property, as defined in § 1.1014-5.

Section 1014(a) of the Code provides generally that the basis of property acquired from a decedent is the fair market value of the property at the date of the decedent's death.

Section 1.1014-4(a)(1) provides that the basis of property acquired from a decedent, as determined under § 1014(a), is uniform in the hands of every person having possession or enjoyment of the property at any time under the will or other instrument or under the laws of descent and distribution. The principle of uniform basis means that the basis of the property (to which proper adjustments must, of course, be made) will be the same, or uniform, whether the property is possessed or enjoyed by the executor or administrator, the heir, the legatee or devisee, or the trustee or beneficiary of a trust created by a will or an inter vivos trust. Where more than one person has an interest in property acquired from a decedent, the basis of such property shall be determined and adjusted without regard to the multiple interests. The basis for computing gain or loss on the sale of such multiple interests shall be determined under § 1.1014-5.

Section 1.1014-5(a)(1) of the regulations defines the term "adjusted uniform basis" as the uniform basis of the entire property adjusted as required by §§ 1016 and 1017 to the date of sale or other disposition of any interest in the property.

Section 1.1014-5(b) provides that in determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in § 1.1001-1(f)(2)) the adjusted basis of which is determined pursuant, or by reference, to § 1014 (relating to the basis of property acquired from a decedent) or § 1015 (relating to the basis of property acquired by gift or by a transfer in trust), that part of the adjusted uniform basis assignable under the rules of § 1014-5(a) to the interest sold or otherwise disposed of shall be disregarded to the extent and in the manner provided by § 1001(e) and paragraph (f) of

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§ 1.1001-1.

An exchange of property results in the realization of gain or loss under § 1001 if the properties exchanged are materially different. Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991). Properties exchanged are materially different if 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 interests 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.

The application of § 1001(a) to trust interests is illustrated by two cases. In Evans v. Commissioner, 30 T.C. 798 (1958), the taxpayer exchanged her income interest in a trust for an annuity, and the court concluded that this was a realization event. Taxpayer's income interest had entitled her to dividends paid by a corporation, the stock of which was owned by the trust. She transferred the income interest to her husband, who agreed in exchange to pay her fixed sums annually until her death.

A contrary result was reached in Silverstein v. United States, 419 F.2d 999 (7th Cir. 1969). In that case, the taxpayer exchanged an interest in a trust for a right to specified annual payments from the remainderman of the trust, and the court held that taxpayer did not as a result dispose of her trust interest. After the transaction, taxpayer was to receive the same annual payments from the remainderman as she had been receiving from the trust. The court distinguished the transaction from that found to be a realization event in Evans: "the amount of Mrs. Evans' interest in the trust was not definitive. It varied with the dividend return on the trust stock. She exchanged this 'uncertainty' for definitely ascertained yearly payments from her husband." 419 F.2d. at 1003.

The proposed trust modification in this case more closely resembles the situation in Evans than that in Silverstein and should be considered a realization event. Grandson currently is entitled to trust income, subject to a floor and a ceiling. Under the proposed order, he would become entitled to annual payments of seven percent of the fair market value of the trust property, with the trustee having some discretion to make additional payments under certain circumstances. Even assuming that the projected payments under the proposed order approximate those that would be made under the current terms of the trust, under the proposed order Grandson would lose the protection of the guaranteed minimum annual payments required by the Performance Chart. He also would not be limited by the Performance Chart's maximum annual payment ceilings. Finally, payments would be determined without regard to trust income. In short, Grandson's interest in the modified trust would entail legal entitlements different from those he currently possesses. This conclusion is reinforced by adding to the Taxpayer's current entitlement the general power of appointment over any trust corpus, even though this was a necessary element in a favorable GST conclusion set forth in issue #3, below.

Pursuant to § 1001(e)(1), the portion of the adjusted uniform basis assigned to Grandson's interest in Trust is disregarded. The exception contained in § 1001(e)(3) is not

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applicable because the entire interest in Trust's assets is not being sold, or otherwise disposed of, to a third party. Accordingly, for purposes of this transaction, Grandson has no basis in his interest in Trust. Therefore, the amount of gain Grandson realizes under § 1001(c) is the amount Grandson realized from the disposition of his assets in Trust. The gain realized by Grandson from the disposition of his interest will be long term capital gain. See Rev. Rul. 72-243, 1972-1 C.B. 233, providing that a sale of an income interest in a trust is a sale of a capital asset within the meaning of §§ 1221 and 1222.

Ruling Request #2: Gift Tax

Section 2501 imposes a tax for each calendar year on the transfer of property by gift during such calendar year by any individual.

Section 2511 provides that, subject to certain limitations, the gift tax applies whether the transfer is in trust or otherwise, direct or indirect, and whether the property transferred is real or personal, tangible or intangible.

It is represented that the portion of Trust to be distributed to Charities 1 through 4 and to the continuing trust for the benefit of Grandson was determined based on arms-length negotiations. As noted, income and principal from Grandson's trust will be distributable only to Grandson during his lifetime, and the principal will be subject to Grandson's general power to appoint the property at his death.

Accordingly, we conclude that Grandson will not be treated as making a gift subject to the gift tax under § 2501 as a result of the proposed agreement and court order.

Ruling Request #3: Generation-Skipping Transfer Tax

Section 2601 imposes a tax on every generation-skipping transfer (GST), which is defined under § 2611 as a taxable distribution, a taxable termination, or a direct skip.

Under § 1433 of the Tax Reform Act of 1986 (the Act), the generation-skipping transfer (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 a transfer under a trust that was irrevocable 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 generation-skipping transfer tax under § 26.2601-1(b) will not cause the trust to lose its exempt status.

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 a beneficial interest

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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.

As discussed above, under the proposed agreement and court order, the amount of Trust corpus in excess of Z dollars will be distributed to Charity 1, Charity 2, Charity 3, and Charity 4 (or their successors) in the same proportion of their current remainder interests in Trust. The remaining assets of Trust will continue to be held in trust for the exclusive benefit of Grandson during his lifetime. In addition, Grandson will have a testamentary general power to appoint the corpus of this trust to anyone, including his estate or the creditors of his estate. Accordingly, the assets of the continuing trust will be included in Grandson's gross estate for estate tax purposes under § 2041(a)(2). Further, Grandson will be treated as the transferor of the trust corpus for GST tax purposes under § 2652(a)(1).

Under these circumstances, based on the facts submitted and the representations made, we conclude that implementation of the proposed order will not cause Trust to lose its exempt status for generation-skipping transfer tax purposes.

In accordance with the power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

A copy of this letter should be attached to any income, gift, estate, or generation-skipping transfer tax returns that you may file relating to this matter.

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 the appropriate party. While this office has not verified any part of the material submitted in support of the request for rulings, it is subject to verification and examination.

Except as specifically ruled above, no opinion is expressed as to the federal tax consequences of the facts described above under the cited provisions or any other provisions of the Code or regulations.

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 Masnik, Branch Chief, Branch 4
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure
copy for § 6110 purposes