

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200448001**

Release Date: 11/26/04

Index Number: 2601.03-01, 643.01-00,
1001.00-00

Person To Contact:

Telephone Number:

Refer Reply To:

CC:PSI:B04 – PLR-101145-03

Date: JULY 21, 2004

In Re:

LEGEND:

Donor =
Trust =

Trust A =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Daughter 1 =

Daughter 2 =

Corporate Trustee =

a =

b =

c =

d =

e =

f =

State =

County Court =

State Law =

Dear :

This is in response to your December 30, 2002 letter and other correspondence requesting a ruling concerning the income and generation-skipping transfer tax (GST) consequences of a proposed modification of Paragraph 7 of Trust.

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You have requested the following rulings:

1. The proposed modification of Paragraph 7 of Trust converting Trust A from an “income-only” trust to a “total return” trust will not cause distributions from or the termination of Trust A to become subject to the generation-skipping transfer (GST) tax under section 2601 of the Internal Revenue Code.
2. Capital gains realized from the sale of Trust A assets and paid to the income beneficiary of Trust A pursuant to the proposed amendment to the Trust agreement will be allocated to distributable net income and taxed to the income beneficiary of Trust A rather than to Trust A in accordance with section 643.
3. The proposed conversion of Trust A from an “income-only” trust to a “total return” trust will not result in a sale and exchange under section 1001 with respect to the income beneficiary, Daughter 1.

The facts submitted are as follows:

Trust was created by Donor pursuant to an agreement dated Date 1. The agreement was amended and restated as of Date 2. Donor died on Date 3 (before September 25, 1985), at which time Trust became irrevocable. No amendments or modifications have been made to Trust since the Date 2 amendments. Daughter 1 and Corporate Trustee currently serve as Co-Trustees of the Trust.

Paragraph 4 of Trust provides that the Donor shall have the right at any time and from time to time during his lifetime, by instrument in writing delivered to the Trustee, to alter, amend, or revoke Trust, either in whole or in part, provided, however, that if altered or amended, the duties, powers and responsibilities of the Trustee shall not be substantially increased without the consent of the Trustee. In case of revocation, the property held in the trust, or that portion as to which the Agreement is revoked, is to be delivered to the Donor by the Trustee, or distributed in accordance with Donor’s written instructions.

Paragraph 6 provides, in part, that upon the death of Donor, the assets then constituting the Trust, together with any other property which may be added to the Trust under Donor’s will or by any other person in any manner, is to be held by the Trustee, in further trust.

Paragraph 6, Section B provides that the trust assets are to be divided into two trust portions. One portion, consisting of a of the assets, is to be held in a separate trust

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referred to as Trust A, for the benefit of Donor's daughter, Daughter 1, if she is then surviving, for her lifetime. The other portion, consisting of b of the assets, is to be held in a separate trust, Trust B, for the benefit of Donor's daughter, Daughter 2, if she is then surviving, for her lifetime.

Paragraph 7 provides that Trust A for the benefit of Daughter 1, shall be administered as follows. The net income from this trust fund is to be paid to Daughter 1 during her lifetime, at convenient times, but at least quarter-annually. The trustee is expressly prohibited from invading trust principal.

Paragraph 7, Section C, provides that upon the death of Daughter 1, or if she fails to survive Donor, the assets remaining in Trust 1 are to be divided into as many portions of substantially equal value as there are children of Daughter 1 then surviving or deceased children of Daughter 1 with issue then surviving, with the share of such issue to equal one portion. The portions for the children of Daughter 1 shall be held in separate trusts pursuant to the provisions of Paragraph 9 of Trust; and each portion set aside for the issue of a deceased child of Daughter 1 shall be paid outright to the issue, by right of representation.

Paragraph 9 provides that each trust for a child of Daughter 1 shall be administered as follows. The Trustee shall pay to each child of Daughter 1 for whom a trust fund is established the net income from the trust fund, at convenient times, but at least quarter-annually, during the continuance of the trust.

Paragraph 9, Section B, provides that principal invasion is not to be "encouraged." However, the Trustee may invade principal upon proof of real need, with the Trustee to keep in mind Donor's expressed intent to preserve principal wherever possible.

Paragraph 9, Section C, provides that upon a child of Daughter 1 attaining the age of 45 years, the Trustee shall distribute to such child all of the then remaining assets of his/her trust fund.

Paragraph 9, Section D, provides, in relevant part, that in the event of the death of a child of Daughter 1 before attaining the age of 45 years, the Trustee is to distribute the assets as follows:

- 1) In the event there is issue then surviving of such deceased child, then to such issue by right of representation;
- 2) In the event there is no issue then surviving of such deceased child, but there is issue of Donor then surviving, then to such issue by right of representation.

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Paragraph 12, Section B(4) provides that the Trustee shall have the power to retain in its absolute discretion, and for such period of time as the Trustee deems advisable, any and all investment and other properties transferred to Trust, without liability for any loss incurred by reason of the retention of such investments or properties; provided, however, the Trustee shall invest c% of the trust principal in equities where there is a likelihood of appreciation and d% or less in government bonds or their equivalent.

Daughter 1 as co-trustee of Trust, petitioned County Court requesting the modification of Paragraph 7 of Trust governing the administration of Trust A. Under Paragraph 7 as modified, the trustee will pay Daughter 1, annually a "Unitrust Amount" equal to f% of the average of the fair market value of the total Trust A assets as of the close of the most recent calendar year and the close of the previous two calendar years. If in any year, the net income generated by the Trust A assets exceeds the Unitrust Amount, the excess amount is to be paid to Daughter 1. The Unitrust Amount is to be paid first from income, then from short-term capital gains, then from long-term capital gains, then, to the extent necessary, from principal.

Each of the interested parties was given proper notice of the petition to the County Court and each party consented, in writing, to the proposed modification. The County Court issued an Order, dated Date 4, approving the modification subject to receipt of a favorable ruling from the Internal Revenue Service.

Section 104 of State Law generally provides that, subject to certain exceptions, a fiduciary may adjust between income and principal to the extent the fiduciary considers necessary, if the fiduciary invests and manages the estate assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary with reference to the trust's income, and the fiduciary determines that such adjustment is necessary to fulfill his duty to administer the trust impartially.

LAW AND ANALYSIS

Ruling 1

Section 2601 imposes a tax on every generation-skipping transfer, which is defined under section 2611 as a taxable distribution, a taxable termination, and a direct skip.

Under section 1433(a) of the Tax Reform Act of 1986 and section 26.2601-1(a) of the Generation-Skipping Transfer Tax Regulations, the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However,

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under section 1433(b)(2)(A) of the Tax Reform Act and section 26.2601-1(b)(1)(i), the tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985, and no addition (actual or constructive) was made to the trust after that date.

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.

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 section 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 generation-skipping transfer or the creation of a new generation-skipping transfer. A modification that is administrative in nature that only indirectly increases the amount transferred will not be considered to shift a beneficial interest in the trust.

Section 26.2601-1(b)(4)(E), Example 8, considers a situation where a trust that is otherwise exempt from the GST tax 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, the appropriate local court approves a modification to the trust that converts A's income interest into the right to receive the greater of the entire income of the trust or a fixed percentage of the trust assets valued annually (unitrust interest) to be paid each year to A for life. The example concludes that the modification does not result in a shift in beneficial interest to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. Rather, the modification can only operate to increase the amount distributable to A and decrease 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 trust will not be subject to the provisions of chapter 13.

In this case, the proposed modification of Paragraph 7 of Trust will not result in a shift of any beneficial interest in Trust A to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the conversion. Further, the proposed modification will not extend the time for vesting of any beneficial interest in Trust A beyond the period provided for in the original trust. Accordingly, based on the

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facts submitted and representations made, we conclude that the proposed modification of Trust A will not cause distributions from or the termination of Trust A to become subject to the GST under section 2601.

Ruling 2

Section 643(a) of the Code defines the term "distributable net income" as the taxable income of a trust with certain modifications. Under section 643(a)(3), gains from the sale or exchange of capital assets are excluded from distributable net income to the extent those gains are allocated to corpus and are not either (A) paid, credited, or required to be distributed to any beneficiary during the year, or (B) paid, permanently set aside, or to be used for charitable purposes. Under section 643(a)(3), losses from the sale of capital assets are also excluded, except to the extent those losses are taken into account in determining the amount of capital gains that are paid, credited, or required to be distributed to any beneficiary during the year.

Section 1.643(a)-3(a) of the Income Tax Regulations provides generally that gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not considered paid, credited, or required to be distributed to any beneficiary unless they are (i) allocated to income under the terms of the governing instrument or local law by the fiduciary on its books or by notice to the beneficiary, (ii) allocated to corpus and actually distributed to the beneficiaries during the taxable year, or (iii) utilized (pursuant to the terms of the governing instrument or the practice followed by the fiduciary) in determining the amount that is distributed or required to be distributed. Accordingly, we conclude that, capital gains that are distributed to the income beneficiary will constitute distributable net income under section 643.

Ruling 3

Section 61(a)(3) provides that gross income includes gains derived from dealings in property. Under section 1.61-1(a) of the Income Tax Regulations, gross income means all income from whatever source derived, unless excluded by law. Gross income includes income in any form, whether in money, property, or services.

Under section 1001(a), gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 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. Under section 1.1001-1(a), the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially in kind or in extent, is treated as income or loss sustained.

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The administration of a trust in conformance with applicable state law 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 treated as a taxable exchange for federal income tax purposes by either the trust or the beneficiaries. Because State Law provides the trustee the power to administer Trust A in the same manner as proposed in the modification, the modification is not treated as an exchange of trust interests by the beneficiaries or the trust.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer and to the taxpayer's other authorized representative.

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 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.

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 L. Masnik
Branch Chief, Branch 4
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure:

Copy of letter for section 6110 purposes