Internal Revenue Service

Department of the Treasury
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Person To Contact:
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Refer Reply To:
CC:PSI:B04 – PLR-169997-03
Date: APRIL 20, 2005

In Re:

Legend:

Husband =
Date 1 =
Wife =
Daughter =
Daughter's Spouse =

Grandchild 1=

Grandchild 2 =

Husband's Will =

Date 2 =
Wife's Will =

Trust 2 =

Date 3 =
Husband's Brother =
Foundation =

Charity 1 =
Charity 2 =

Bank 1 =
Great Grandchild 1 =
Great Grandchild 2 =
Great Grandchild 3 =
Great Grandchild 4 =
Great Grandchild 5 =
State =
Date 4 =

Agreement =
Bank 2 =
Individual =
Date 5 =
Date 6 =

Court =

State's Unitrust Statute =

Dear :

This is in response to a letter dated December 2, 2004, and other correspondence, requesting rulings regarding the income and generation-skipping transfer (GST) tax consequences of proposed modifications of a trust.

Facts

The facts submitted and representations made are as follows. Husband died testate on Date 1, survived by Wife, Daughter, Daughter's Spouse, Grandchild 1, and Grandchild 2, the two children of Daughter and Daughter's Spouse.

Husband's Will provided for the residue of his estate to be placed in two trusts, "Trust Fund A," over which Wife held a testamentary general power of appointment, and "Trust Fund B." Wife died testate on Date 2 prior to September 25, 1985, survived by Daughter, Daughter's Spouse, Grandchild 1, and Grandchild 2. In Wife's Will, Wife bequeathed her residuary estate to Trust 2, a revocable trust created by Wife during her

lifetime. In addition, Wife exercised her power of appointment over Trust Fund A by appointing the Trust Fund A corpus to Trust 2. No additions have been made to Trust 2 after September 25, 1985.

Under the terms of Trust 2, after Wife's death, one-tenth of the net income was to be distributed to Daughter's living children and the balance of the net income was to be distributed to Daughter. Trust 2 provides that upon Daughter's death, with living children surviving her, the net income is to be distributed "in equal shares, per stirpes, to and among such living child or children and the issue of any predeceased child or children." Trust 2 further provides that "[i]f in the course of events," Daughter's Spouse or Husband's Brother are the sole survivors of Wife, then the net income will be paid to Daughter's Spouse for life and then to Husband's Brother. Trust 2 will terminate upon the death of the last survivor among Husband, Daughter, Daughter's Spouse, Husband's Brother, Grandchild 1, and Grandchild 2. At that time, the trust property will be distributed to the children of Grandchild 1 and Grandchild 2 or to the issue of a deceased child. If there are no living descendants of Daughter when Trust 2 terminates, the trustee of Trust 2 will set aside all of the assets of Trust 2 in Foundation. The trustee will pay one-half of the income of Foundation to Charity 1 and one-half to Charity 2.

Bank 1 was named as the original trustee of Trust 2. The current trustee is Bank 2, a successor in interest of Bank 1.

Daughter died on Date 3, survived by Daughter's Spouse, Grandchild 1 and Grandchild 2. Husband's Brother predeceased Daughter. Daughter's Spouse, Grandchild 1, and Grandchild 2 are still living. Grandchild 1's one child, Great Grandchild 1, is now an adult. Grandchild 2 now has two adult children, Great Grandchild 2 and Great Grandchild 3, and two children who are still minors, Great Grandchild 4 and Great Grandchild 5.

Grandchild 1 and Grandchild 2 have each received 50 percent of the net income of Trust 2 since Daughter's death.

On Date 4 after September 25, 1985, Agreement was executed to modify Trust 2. Agreement was signed by Bank 2, as the trustee of Trust 2; Daughter's Spouse, Grandchild 1 and Grandchild 2, as the current income beneficiaries of Trust 2; Great Grandchild 1, Great Grandchild 2, and Great Grandchild 3, as the adult contingent income and remainder beneficiaries of Trust 2; Individual, as guardian ad litem for the minor, unborn, and not-yet-adopted contingent income and remainder beneficiaries of Trust 2; and Charity 1 and Charity 2

Agreement makes three modifications to Trust 2. First, under Agreement as amended by the parties (the "Amendment"), the right of the income beneficiaries to receive the trust net income will be converted, pursuant to State's Unitrust Statute, into

the right to receive proportionate shares of a unitrust amount, the Total Annual Return Amount. The Total Annual Return Amount is computed by multiplying: (A) a fraction, the numerator of which is the sum of the fair market values of the trust corpus on the first business day of the current calendar year and on the first business days of the immediately preceding two calendar years (less any trust liabilities for such preceding years, including any undistributed amounts of income attributable to such preceding years) and the denominator of which will be three; by (B) 4.25 percent. However, for the first two calendar years, the Total Annual Return Amount will be 4.25 percent of the fair market value of the trust corpus on the first business day of the current calendar year.

Second, under Agreement, the provision designating Foundation as the final contingent remainder beneficiary will be changed to provide that the corpus will be paid directly to Charity 1 and Charity 2.

Third, Agreement creates an investment advisory committee that will approve or reject the trustee's recommendations regarding investment decisions. The trustee must notify the committee of a proposed action and the committee must respond within a specified time. If the committee does not respond, the trustee may proceed with the proposed action. However, the trustee may sell assets without being subject to these notification and approval requirements to the extent necessary to pay the Total Annual Return Amount, authorized trustee fees, and other reasonable trust expenses. The committee can also direct the trustee to buy, sell, exchange, or retain assets but the trustee need not follow these directions. The initial committee will be comprised of Grandchild 1 and Grandchild 2.

On or about Date 5, Bank 2, as trustee, filed a petition with the Court requesting the Court to issue an order approving the modifications to Trust 2 under Agreement, conditioned upon the trustee's receipt of a favorable private letter ruling from the Internal Revenue Service. Each of the parties to the Agreement received notice of the petition and consented to the request. On Date 6, Court issued the requested order.

It is represented that Bank 3, as trustee, will file a petition with the Court requesting the Court to issue an order granting approval of the modification to Trust 2 under the Amendment to Agreement. Each of the parties to the Agreement and the Amendment will receive notice of the petition and consent to the request.

The taxpayers have requested the following rulings:

1. The proposed modifications to Trust 2 under Agreement and the Amendment will not cause Trust 2 to lose its status as a trust that is exempt from the GST tax by reason of § 1433(b)(2)(A) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i).

2. The proposed modifications to Trust 2 under Agreement and the Amendment will not cause the beneficiaries of Trust 2 or the trust to realize gain or loss or income under §§ 61 or 1001.

Ruling Request #1:

Section 2601 imposes a tax on each generation-skipping transfer made by a transferor to a skip person.

Under § 1433(a) of the Tax Reform Act of 1986, the generation-skipping transfer tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) of the Tax Reform Act and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to a 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 generation-skipping transfer tax will not cause the trust to lose its exempt status. The regulation provides that the rules contained in the paragraph are generally applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. Unless noted otherwise, 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 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 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. 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. 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 that for purposes of determining the meaning of the term income as used in various Internal Revenue Code sections relating to the income taxation of trusts, 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. Under the regulation, 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)(E), Example 11, considers a situation where a trust administered under the laws of State X, 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 State X 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. For a trust established prior to 2002, the statute provides that the new definition of income will apply only if all the beneficiaries who have an interest in the trust consent to the change within two years after the effective date of the statute. The statute provides specific procedures to establish the consent of the beneficiaries. A and A's issue consent to the change in the definition of income within the time period, and in accordance with the procedures, prescribed by the state statute. The example concludes that 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 of the Internal Revenue Code. 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. Finally, the example states that the conclusions in this example would be the same if the beneficiaries' consent was not required, or, if the change in administration of the trust occurred because the situs of the trust was changed to State X from a state whose statute does not define income as a unitrust amount or if the situs was changed to such a state from State X.

In the present case, Trust 2 was irrevocable on September 25, 1985. It is represented that no additions, actual or constructive, were made to Trust 2 after that date.

Regarding the modification under Agreement and the Amendment converting the annual distribution to be made to the trust beneficiaries from net income to a unitrust amount, State’s Unitrust Statute generally authorizes the conversion of an “income trust” (a trust that describes the amount to be distributed to a beneficiary by referring to

the trust's income) to a "total return unitrust," generally, a trust that pays out a unitrust amount computed as a percentage of the fair market value of the trust. The unitrust rate, that is, the percentage of the fair market value of the trust to be distributed, must be no less than 3 percent and no more than 5 percent. In the present case, the trustee, the beneficiaries, and the guardian ad litem for minor, unborn, and not-yet-adopted contingent income and remainder beneficiaries of the trust have agreed in writing to the conversion of the trust from an income trust into a 4.25 percent unitrust. Further, the trustee will petition the appropriate state probate court for approval of this conversion. In the instant case, State's Unitrust Statute meets the requirements of §1.643(b)-1. Therefore, in accordance with § 26.2601-1(b)(4)(i)(D), the conversion and administration of the trust pursuant to State's Unitrust Statute, as described above, 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. See § 26.2601-1(b)(4)(i)(E), Example 11.

Finally, the proposed modification substituting Charity 1 and Charity 2 for Foundation as contingent remainder beneficiaries does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation 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. The modification creating an investment advisory committee is administrative in nature.

Accordingly, based on the facts submitted and the representations made and provided the proposed conversion meets the requirements of State's Unitrust Statute, we conclude that the proposed modifications to Trust 2 under Agreement and the Amendment will not cause Trust 2 to lose its status as a trust that is exempt from GST tax by reason of § 1433(b)(2)(A) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i).

Ruling Request #2:

Section 61(a)(3) provides that gross income includes gains derived from dealings in property. Under §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 realized in any form, whether in money, property, or services.

Under §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 §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 §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.

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

Section 1.1001-1(a) of the Income Tax Regulations 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 loss sustained.

Section 1.1001-1(c)(1) provides that a loss is not ordinarily sustained prior to the sale or other disposition of the property for the reason that until such sale or other disposition occurs there remains the possibility that the taxpayer may recover or recoup some of the adjusted basis of the property. Until some identifiable event fixes the actual sustaining of a loss and the amount thereof, it is not taken into account.

The proposed modifications under Agreement to substitute Charity 1 and Charity 2 as remote contingent remainder beneficiaries in place of Foundation and to create an investment advisory committee will not be treated as a taxable exchange for federal income tax purposes by either the trust or the beneficiaries.

The third proposed modification under Agreement and the Amendment will convert, pursuant to State's Unitrust Statute, the income beneficiaries' income interests into the right to receive their proportionate shares of a unitrust amount. As discussed above, under State's Unitrust Statute, a trustee may convert an income trust to a unitrust without court approval if the unitrust percentage is no less than 3 percent nor more than 5 percent if the rate is agreed upon in writing by the trustee and the beneficiaries. Here, the trustee and beneficiaries have agreed in writing to the conversion of the trust from an income trust into a 4.25 percent unitrust, and this agreement will be presented to the appropriate state probate court for approval. In Example 11 of § 26.2601-1(b)(4)(i)(E), an income trust was converted to a unitrust under a state statute authorizing such conversions. The example concludes that "neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes."

Accordingly, based on the facts submitted and the representations made and provided the proposed conversion meets the requirements of State's Unitrust Statute, we conclude that no gain or loss will recognized under § 61 or §1001 by Trust 2, or any beneficiary of Trust 2 as a result of the proposed modifications.

Except as specifically ruled herein, we express no opinion on the federal tax consequences of the proposed modifications of Trust 2 under the cited provisions or under any other provisions of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,

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

Enclosure
Copy for section 6110 purposes

cc: