

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200747017**
Release Date: 11/23/2007

Third Party Communication: None
Date of Communication: Not Applicable

Index Number: 2601.04-01, 2501.01-00,
1001.00-00

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B04
PLR-151533-06
Date: August 9, 2007

LEGEND:

Trust =
Year 1 =
Husband =
Wife =
Son 1 =
Daughter 1 =
Son 2 =
Son 3 =
Daughter 2 =
Daughter 3 =
Date 2 =
Date 3 =
State Court =
State Statute =

Date 4 =
State =

Dear :

This responds to your representative's letter dated April 16, 2007, and prior correspondence, in which you request a ruling on the income, gift, and generation-skipping transfer (GST) tax consequences of the proposed conversion of Trust to a total return unitrust, as described below.

FACTS

The facts and representations submitted are summarized as follows.

In Year 1, Husband and Wife (the "Settlors") created Trust, an irrevocable trust, for the benefit of their six children and their children's issue. Trust was created prior to September 25, 1985, and there have been no additions (actual or constructive) to Trust after September 25, 1985. Husband and Wife are currently deceased.

Article V of Trust provides, in part, that one-fourth of the net income of Trust shall be set aside and shall be invested by the trustees in property which shall be added to the corpus of the trust estate, or in permanent improvements upon real estate constituting a part of the trust estate, or in payment of indebtedness which constitutes a lien upon the trust property.

Article V further provides that three-fourths of the net income of Trust shall be paid annually or more frequently, as follows: One-half to Husband during his lifetime, and thereafter to Wife, for her lifetime; one-twelfth to Son 1 and his lawful heirs; one-twelfth to Daughter 1 and her lawful heirs; one-twelfth to Son 2 and his lawful heirs; one-twelfth to Son 3 and his lawful heirs; one-twelfth to Daughter 2 and her lawful heirs; and, one-twelfth to Daughter 3 and her lawful heirs. Finally, Article V provides that if at any time during the trust period, any beneficiary shall die without lawful surviving heirs, the deceased beneficiary's share of the net income shall be equally divided among the other beneficiaries, per stirpes and not per capita. The Settlers' expressed intention is that their children and the lineal descendants of their children will, after the death of the Settlers, enjoy three-fourths of the net income of the trust property.

Trust shall terminate on Date 2, which is 21 years after the death of the last surviving measuring life. Article XII provides that at the expiration of the trust period, the trustees shall distribute the remaining trust corpus to the lineal descendants of the Settlers and the children of Settlers on a per stirpes basis.

Trust currently has five trustees, all of whom are beneficiaries of Trust.

On Date 3, the trustees of Trust petitioned State Court to convert Trust from an income trust to a total return unitrust pursuant to State Statute. The petition states that the trustees will use five percent as the percentage to calculate the unitrust amount. The petition affirms that one-fourth of the unitrust amount will be set aside in accordance with Article V of Trust.

State Statute provides, in part, that if a trustee desires to convert an income trust to a total return unitrust, the trustee may petition the circuit court for such order as the trustee deems appropriate. The term "income trust" is defined as a trust created by

either an inter vivos or a testamentary instrument that directs or permits the trustee to distribute the net income of the trust to one or more persons, either in fixed proportions or in amounts or proportions determined by the trustee and regardless of whether the trust directs or permits the trustee to distribute the principal of the trust to one or more such persons. The term "unitrust amount" is defined as the amount determined by multiplying the fair market value of the assets determined at least annually by the percentage calculated under the statute. Under the statute, the percentage used to calculate the unitrust amount cannot be greater than 5 percent or less than 3 percent.

On Date 4, State Court issued an order authorizing the managing trustee to convert Trust from an income trust to a total return unitrust.

Rulings have been requested that the proposed conversion of Trust from an income trust to a total return unitrust, pursuant to the laws of State: (1) will not cause Trust to become subject to the provisions of Chapter 13 of the Internal Revenue Code ("Code"); (2) will not cause Trust or any beneficiary to have made a gift for gift tax purposes; (3) will not cause Trust or any beneficiary to realize gain under § 1001 of the Code for income tax purposes.

Ruling 1

Section 2601 imposes a tax on every GST. 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 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 (or out of income attributable to corpus so added).

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 because it was irrevocable prior to September 25, 1985, 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 GST 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. 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 sections of the Code 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 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.

Section 26.2601-1(b)(4)(i)(E), Example 11, considers the conversion of an income interest to a unitrust interest under a state statute. In the example, the trust is otherwise exempt from the GST tax because it was irrevocable prior to September 25, 1985, and provides that trust income is payable to A for life and, upon A's death, 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 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 the 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, the example states that, under the facts therein, 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.

In the present case, State Statute meets the requirements of § 1.643(b)-1 and § 26.2601-1(b)(4)(i)(D). Therefore, the conversion of Trust pursuant to State 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.

Accordingly, based on the facts submitted and the representations made, we conclude that the proposed conversion of Trust to a total return unitrust pursuant to State Statute will not cause Trust 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 2

Section 2501(a) imposes a tax for each calendar year on the transfer of property by gift during the calendar year by any individual, resident or nonresident.

Section 2511(a) provides that the tax imposed by section 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 the gift is made in property, the value thereof at the date of the gift is considered the amount of the gift. Section 2512(b) provides that where property is transferred for less than adequate and full consideration in money's worth, then the amount by which the value of the property exceeds the value of the consideration is deemed to be a gift, and is included in computing the amount of gifts made during the taxable year.

Treas. Reg. § 26.2601-1(b)(i)(4)(E), Example 11, concludes that the administration of a trust pursuant to a state statute that meets the requirements of § 1.643(b)-1 and § 26.2601-1(b)(4)(i)(D) will not result in any trust beneficiary being treated as having made a gift for federal gift tax purposes. Because State Statute meets the requirements of § 1.643(b)-1 and § 26.2601-1(b)(4)(i)(D), we conclude that the conversion and administration of Trust pursuant to State Statute will not cause the beneficiaries of Trust to be treated as making taxable gifts for federal gift tax purposes under § 2501.

RULING 3

Section 61(a)(3) provides that gross income includes gains derived from dealings in property. Under § 1.61-1(a), 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.

In the present case, State Court has approved, pursuant to State Statute, the conversion of the beneficiaries' income interests into the right to receive their proportionate shares of a unitrust amount. 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 Statute, we conclude that no gain or loss will recognized under § 61 or § 1001 by Trust or any beneficiary of Trust as a result of the proposed modifications.

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 ruling contained in this letter is 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 ruling, it is subject to verification on examination.

Sincerely,

Melissa C. Liquerman
Senior Technician Reviewer, Branch 2
Passthroughs & Special Industries