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Person To Contact:
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Legend

Trust 1 =

Trust 2 =

State =
Grantor =
Date 1 =
Court =
Child 1 =
Date 2 =
Child 2 =
Date 3 =
Date 4 =
Date 5 =
Statute =

Dear :

This letter responds to your letter, dated August 11, 2006, and subsequent correspondence, requesting income, gift and Generation-Skipping Transfer (GST) tax rulings with respect to the proposed conversion of Trust to a total return trust under State law.

The facts and representations are as follows: Grantor created two irrevocable trusts on Date 1. At the request of the trustees, Court divided the irrevocable trust into four separate trusts on Date 2. Trust 1 and Trust 2 are two of the eight trusts created by the Date 2 court order and each is held for the benefit of Child 1 and his descendants. The dispositive provisions of Trust 1 and Trust 2 are identical.

Date 1 and Date 2 are before September 25, 1985. No additions (actual or constructive) have been made to Trust 1 or Trust 2 since September 25, 1985. Each trust is governed by State law.

Under the terms of each of the original trust agreements and the Date 2 Court order, after Child 1's death, Child 1 may direct the payment of up to one-third of the net income in his last will and testament to his surviving spouse. The balance of the net income, or all of the net income if none becomes payable to a surviving spouse, shall be paid to Child 1's issue from time to time surviving per stirpes. Child 1 may, by will, change the proportion in which his issue shall share in the net income by exercise of a limited power of appointment. If Child 1 dies without issue before the termination of the trust, the trust assets shall be added to the shares of the remaining children in the same proportion that such shares bear to each other.

Under the terms of each of the original trust agreements and the Date 2 Court order, each trust shall continue until twenty years after the death of the last surviving of eight named individuals. Child 2 was the last surviving named individual. Child 2 died on Date 3. Upon termination of a trust, the trust estate shall be paid to the person(s) then in receipt of the income. If a spouse is currently receiving income, a share of the trust necessary to produce such income shall continue to be held in trust during the spouse's life but the person(s) who would have received the income shall immediately have a vested interest in the principal withheld. The trustees may choose to purchase an annuity for the spouse and make immediate distribution of the entire trust estate.

Child 1 died on Date 4. Under Article Three of his will, executed on Date 5, Child 1 exercised his rights under each trust to change the percentage of net income paid to his issue but did not direct payment of any net income to a surviving spouse. Income from each trust is currently distributed in accordance with the percentages set out in Child 1's will.

State Statute permits a court to convert a trust to a total return trust or unitrust if the court determines that the conversion will enable the trustee to better carry out the purposes of the trust and that the conversion is in the best interests of the beneficiaries. Statute provides that following conversion of a trust to a total return trust, "income" in the governing instrument means an annual amount equal to a percentage of the net fair market value of the total trust assets averaged over a three-year period. Finally, Statute provides that a court has the power to determine the percentage of the total value of the trust assets to be distributed from a total return trust.

The trustees of each trust have filed a complaint in Court requesting that the court convert Trust 1 and Trust 2 to a total return trusts under Statute and that Court approve a 3% distribution percentage from each trust after the conversion. The complaint further requests the court declare that on termination, the assets from each trust will be distributed to the persons then in receipt of a portion of the unitrust amount in the same proportions as the unitrust amount is then being paid. The trustees further propose to consolidate Trust 1 and Trust 2. After the conversion and merger, the unitrust amount will be divided among the beneficiaries as directed in Child 1's will.

The trustees have requested rulings that the proposed conversions of Trust 1 and Trust 2 to a total return trusts and subsequent merger (1) will not cause either trust to lose its status as exempt from the GST tax, (2) will not cause any beneficiary to have made a gift for gift tax purposes, (3) will not cause either trust or any beneficiary to realize capital gain from an exchange of a trust interest for income tax purposes, and (4) will not change the basis or holding periods of the assets of either trust.

Rulings 1 and 2

Section 2501 of the Internal Revenue Code imposes a tax on the transfer of property by gift by an individual.

Section 2511 provides that the tax imposed by § 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 a gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.

Section 2601 imposes a tax on every generation-skipping transfer.

Section 2611(a) defines the term "generation-skipping transfer" as a taxable distribution, a taxable termination, and a direct skip.

Under § 1433(b)(2)(A) of the Tax Reform Act of 1986 and §26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the generation-skipping transfer tax provisions do not apply to any generation-skipping transfer under a trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985. However, this exemption does not apply if additions (actual or constructive) are made to the trust after September 25, 1985.

Section 26.2601-1(b)(1)(ii)(A) of the Generation-Skipping Transfer Tax Regulations provides that any trust in existence on September 25, 1985, will be considered an irrevocable trust except as provided in §26.2601-1(b)(ii)(B) or (C), which relate to property includible in a grantor's gross estate under §§ 2038 and 2042.

Section 26.2601-1(b)(4) 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)(1), (2), or (3) (hereinafter referred to as an exempt trust) will not cause the trust to lose its exempt status. In general, unless specifically provided otherwise, the rules contained in §26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. 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 for purposes of this section, 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 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, then 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 a beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13. Further, under the facts of the example, 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.

The trustees represent that Trust 1 and Trust 2 were irrevocable on September 25, 1985 and that there were no additions to either trust after September 25, 1985.

The facts in this case are similar to those set forth in Example 11 of § 26.2601-1(b)(4)(i)(E), which provides that the conversion of an income interest to a unitrust interest pursuant to state statute will not be considered to shift a beneficial interest in a trust for GST purposes. Example 11 further concludes that 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.

Provided the proposed conversion meets the requirements of State Statute and an order from State Court approving the conversion is obtained, we conclude that the conversion of the income interests in Trust 1 and Trust 2 to unitrust interests and the subsequent merger will not be considered to shift any beneficial interest in either trust and, therefore, will not cause either trust to lose its status as exempt from the GST tax. We further conclude that the proposed modifications will not result in any beneficiary being treated as having made a taxable gift for federal gift tax purposes.

Ruling 3

Section 61(a)(3) and (15) provides that gross income means all income from whatever source derived, including gains derived from dealings in property and income from an interest in an estate or trust.

Under § 1001(a) of the Code, 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) of the Income Tax Regulations, 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(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, the loss is not taken into account.

An exchange of property results in the realization of gain or loss under § 1001 if the properties are materially different. *Cottage Savings Assoc. v. Commissioner*, 499 U.S. 554 (1991). Properties exchanged are materially different if the 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 Supreme Court held that mortgage loans made to different obligors and secured by different homes embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans. *Id*. 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.

Section 1.643(b)-1 provides a comprehensive definition of “income” as that term applies to trusts and estates. It provides, in part, that items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal. However, 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 1.643(b)-1 further provides that a switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of § 1001.

In the present case, the preliminary question is whether the trustees and beneficiaries of the Trust 1 and Trust 2 will have the same property interests and legal entitlements as a result of the proposed conversion. Under State Statute, a conversion to a total return trust may be made upon the court's determination that the conversion will enable the trustee to better carry out the purposes of the trust. In addition, and under the facts presented, there is to be no material change in property interests or legal entitlements for Trust 1, Trust 2, the trustees, or the beneficiaries. If the conversion of the trusts to total return trusts does not result in a material change in property interest or legal entitlements, there is no occasion for realizing taxable gain or loss under § 1001.

The same analysis applies in determining the tax consequences of the merger of the two trusts. In this case, the interests of all taxpayers before and after the proposed merger of Trust 1 and Trust 2 remain the same because each trust has the same beneficiaries and identical terms. The exchanged properties are not materially different because they do not involve legal entitlements that are different in kind or confer different rights and powers. Neither the consolidation of Trust 1 and Trust 2, nor a deemed distribution of the assets of both to the resulting trust, result in gain or loss realization to any taxpayer in this case.

<u>Ruling 4</u>

Section 1015(b) provides that if property is acquired by a transfer in trust (other than a transfer in trust by a gift, bequest, or devise), the basis shall be the same as it would be in the hands of the grantor increased by the amount of gain or decreased by the amount of loss recognized to the grantor on such transfer.

Section 1.1015-2(a)(1) provides that in the case of property acquired after December 31, 1920, by transfer in trust (other than by transfer in trust by gift, bequest, or devise) the basis of property so acquired is the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on the transfer under the law applicable to the year in which the transfer was made. If the taxpayer acquired the property by transfer in trust, this basis applies whether the property be in the hands of the trustee, or the beneficiary, and whether acquired prior to termination of the trust and distribution of the property, or thereafter.

Section 1223(2) provides that, in determining the period for which the taxpayer has held property however acquired, there shall be included the period for which such property was held by any other person, if under Chapter 1 of Subtitle A such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person. See also § 1.1223-1(b).

Based on the information submitted and the representations made, we conclude that because § 1001 does not apply to the conversion and merger of the Trust 1 and Trust 2 assets, under § 1015, the basis of the assets received by the resulting trust will be the same after the conversion and merger as the basis of those assets before. Furthermore, pursuant to § 1223(2), the holding period of each assets in the resulting trust will include the holding period of that asset in the hands of each original trust.

Except as expressly provided herein, no opinion is expressed or implied concerning the federal 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(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Pursuant to the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer's representatives.

Sincerely,

Melissa C. Liquerman

Melissa C. Liquerman
Senior Technician Reveiwer, Branch 2
(Passthroughs & Special Industries)

Enclosure
Copy for § 6110 purposes