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Person To Contact: \_\_\_\_\_, ID No.

Telephone Number:

In Re:

Refer Reply To:  
CC:PSI:B04  
PLR-126361-14  
Date:  
December 05, 2014

Legend:

- Grantor =
- Trust =
- Daughter =
- Granddaughter =
- Granddaughter's Trust =
  
- Foundation =
- State =
- State Statutes =
  
- Court =
  
- Year =
- Date 1 =
- Date 2 =
- Date 3 =
- Date 4 =
- Date 5 =
- Date 6 =
- Date A =
- Y =

Dear \_\_\_\_\_ :

This letter responds to your letter, dated June 27, 2014, and subsequent correspondence, submitted by your authorized representative requesting income, gift, and generation-skipping transfer (GST) tax rulings with respect to the proposed conversion of an income-only trust to a total return unitrust pursuant to State Statutes.

Grantor established an irrevocable trust (Trust) on Date 1 (a date prior to September 25, 1985). Grantor died on Date 2 (a date prior to September 25, 1985). The trustees of Trust represent that there have been no additions, actual or constructive, to Trust (or any trust created under Trust) after September 25, 1985.

Paragraph 3(e) of Trust provides that on Date A the trustees shall divide Trust's assets into equal shares for each of Grantor's grandchildren who are living on Date A and for each of Grantor's grandchildren who die before Date A leaving issue who are living on Date A. Any share set aside under subparagraph (e) will continue to be held in trust.

Date A occurred on Date 3. On Date 3, the trustees established separate trusts for each grandchild, including a trust for Granddaughter (Granddaughter's Trust). This private letter ruling pertains to Granddaughter's Trust.

Paragraph 3(f)(ii) provides that after Grantor's death the trustees may accumulate the trust income of a grandchild's trust or may, at any time, and from time to time, pay over all or any part of the current and accumulated income to the grandchild for whom the trust was established during his or her lifetime.

Paragraph 3(f)(iii) provides that upon the death of the grandchild, the grandchild's trust estate is to be distributed to that grandchild's issue pursuant to that grandchild's testamentary limited power of appointment. In default of this exercise, the trust estate is to be distributed, *per stirpes*, to the issue of that grandchild then living, if any, and if none, *per stirpes*, to the then living issue of Daughter, if any, and if none, to Foundation.

On Date 4, State enacted State Statutes allowing a trustee, other than an interested trustee, or where two or more persons are acting as trustees, a majority of the trustees who are not interested trustees (in either case hereafter, "trustee"), in the trustee's sole discretion and without court approval, to (1) convert an income trust to a total return unitrust, (2) reconvert a total return unitrust to an income trust, or (3) change the percentage used to calculate the unitrust amount or the method used to determine the fair market value of the trust if all of the following apply: (a) the trustee adopts a written policy for the trust providing; (i) in the case of a trust being administered as an income trust, that future distributions from the trust will be unitrust amounts rather than net income as determined pursuant to the State Uniform Principal and Income Act; (ii) in the case of a trust being administered as a total return unitrust, that future distributions from the trust will be net income rather than unitrust amounts; or (iii) that the percentage used to calculate the unitrust amount nor the method used to determine the fair market value of the trust will be changed as stated in the policy. The percentage to be used by the trustee in determining the unitrust amount must be a reasonable current return from the trust, but not less than 3 percent nor more than 5 percent, taking into account the intentions of the settlor of the trust as expressed in the terms of the trust, the needs of

the beneficiaries, general economic conditions, projected current earnings and appreciation for the trust assets, and projected inflation and its impact on the trust.

On Date 5, the trustees of Granddaughter's Trust petitioned Court pursuant to the State Statutes requesting that Court order the conversion of Granddaughter's Trust to a total return unitrust. On Date 6, Court issued an Order, effective as of Date 4, in Year, converting Granddaughter's Trust to a total return unitrust and approving the modification of the terms of Granddaughter's Trust to provide that the annual unitrust amount equals Y percent of the fair market value of the assets of Granddaughter's Trust. The Order made no other changes to the terms of Granddaughter's Trust and is contingent upon receipt of a favorable private letter ruling.

The trustees have requested the following rulings.

(1) The conversion of Granddaughter's Trust to a total return unitrust pursuant to State Statutes effective for Year and future years will not cause Granddaughter's Trust to lose its status as exempt from the GST tax.

(2) The conversion of Granddaughter's Trust to a total return unitrust pursuant to State Statutes effective for Year and future years will not cause any beneficiary of Granddaughter's Trust to be deemed to have made a gift for gift tax purposes.

(3) The conversion of Granddaughter's Trust to a total return unitrust pursuant to State Statutes effective for Year and future years will not cause Granddaughter's Trust or any beneficiary of Granddaughter's Trust to realize capital gains from an exchange of a trust interest for income tax purposes.

#### Law and Analysis - Ruling 1:

Section 2601 of the Internal Revenue Code imposes a tax on every GST. Section 2611(a) defines a GST 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 GST tax provisions do not apply to any GST under a trust 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) 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 GST 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 GST 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 or the creation of a new GST. 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 in 1980, Grantor, a resident of State X, established an irrevocable trust for the benefit of Grantor's child, A, and A's issue. The trust 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, State X 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. 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 administration of the trust, in accordance with the state statute defining income to be a 4 percent 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, 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. Similarly, 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.

The trustees represent that Trust was irrevocable on September 25, 1985, and that there have been no additions, constructive or otherwise, to Trust (or any trust created under trust including Granddaughter's Trust) after September 25, 1985. Consequently, Granddaughter's Trust is currently exempt from GST tax.

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. The conversion meets the requirements of the State Statutes and is pursuant to Court's Order. Accordingly, based upon the facts submitted and the representations made, we conclude that the conversion Granddaughter's Trust to a total return unitrust pursuant to State Statutes effective for Year and future years will not cause Granddaughter's Trust to lose its status as exempt from the GST tax.

#### Ruling 2:

Section 2501(a)(1) imposes a tax for each calendar year on the transfer of property by gift during such calendar year by an individual.

Section 2511(a) provides that the tax imposed by § 2501 will apply 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.

In this case, the conversion of Granddaughter's Trust to a total return unitrust pursuant to State Statutes effective for Year and future years does not increase, decrease, or otherwise change any beneficiary's beneficial interest in Granddaughter's Trust. Accordingly, based upon the facts submitted and the representations made, we conclude that the conversion of Granddaughter's Trust to a total return unitrust pursuant to State Statutes effective for Year and future years will not cause any beneficiary of Granddaughter's Trust to be deemed to have made a gift for gift tax purposes.

Ruling 3:

Section 61(a)(3) provides that, except as provided in subtitle A, gross income means all income from whatever source derived, including income from dealings in property.

Section 1.61-1(a) provides that 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.

Section 1001(a) provides that the 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 adjusted basis provided in § 1011 for determining loss over the amount realized.

Section 1.1001-1(a) provides that, except as otherwise provided in subtitle A, the gain or loss realized from the conversion of property into cash, or from the exchange of property differing materially in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received.

Section 643(b) provides, in relevant part, that for purposes of this subpart and subparts B, C, and D, the term "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law.

Section 1.643(b)-1 provides, in relevant part, that for purposes of subparts A through D, part I, subchapter J, chapter 1, "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Trust provisions that depart

fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of § 642(b) (relating to the personal exemption) and § 651 (relating to simple trusts). Thus, 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 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 1.643(b)-1 further provides, in relevant part, that allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods. A switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of § 1001 and will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries.

Based on the facts submitted and representations made, we conclude that the conversion of Granddaughter's Trust to a total return unitrust pursuant to State Statutes, as described above, will not constitute a recognition event for purposes of § 1001 and no gain or loss will be recognized to Granddaughter's Trust or to any beneficiary of Granddaughter's Trust as a result of the conversion effective for Year and future years.

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.

Sincerely,

Lorraine E. Gardner

Lorraine E. Gardner  
Senior Counsel, Branch 4  
(Passthroughs & Special Industries)

Enclosures:  
Copy for section 6110 purposes

cc: