

Dear _____ :

This letter responds to your representative's letter of September 23, 2016, and other correspondence, requesting a ruling concerning the generation-skipping transfer (GST) tax consequences of proposed modifications to a trust.

FACTS

The facts and representations submitted are summarized as follows.

Decedent died testate on Date 1 (a date prior to December 26, 1985). Under Paragraph Sixth of Decedent's will, Decedent established Trust for the benefit of Decedent's daughter (Daughter) and her descendants.

Under Paragraph SIXTH (a) of the will, for so long as Daughter or any of Daughter's children then living survives, and for twenty-one years thereafter, all of the net Trust income is to be paid one-half to Daughter during her life and the other one-half to Grandchild 1, Grandchild 2, and Grandchild 3 and their issue until the last survivor of Grandchild 1, Grandchild 2, and Grandchild 3 has died. Distributions are to be made quarterly.

Under Paragraph SIXTH (b) of the will, on the death of the last survivor of Grandchild 1, Grandchild 2, and Grandchild 3 (and after the death of Daughter), the Trust corpus is to be divided into three equal shares and administered for twenty-one years as follows: the income from one share is to be paid quarterly to the issue of Grandchild 1; the income from the second part is to be paid quarterly to the issue of Grandchild 2; and the income from the third part is to be paid quarterly to the issue of Grandchild 3. On the expiration of the twenty-one years, the trustees are to sell the Trust corpus and divide the proceeds into three equal shares and pay one share to the issue of Grandchild 1, one share to the issue of Grandchild 2, and one share to the issue of Grandchild 3. In the event of the death of all three of Decedent's grandchildren without leaving issue, Trust is to be reduced to cash and paid to Decedent's heirs in accordance with the statute of descent and distribution.

Trust was initially administered in State A. On Date 2, Court A (in State A) signed a final order modifying the method of determining Trust income. Under the modification, Paragraph SIXTH (a) and (b) provides that the annual distribution amount to be paid by the trustees (during the Trust term) is to be an amount equal to the greater of the Trust's annual net income or x percent of the Trust's total value as determined on the first day of each year. In all other respects, the provisions of the modified Trust are identical to those of the original Trust. The court order referred to State A Statute as the basis for the modification. The Date 2 order was contingent on receipt of a ruling from the

Internal Revenue Service that the modification will not cause Trust to lose its exempt status for purposes of the GST tax under § 2601 of the Internal Revenue Code (Code), which ruling was issued on Date 3.

Subsequently, the situs of Trust was changed to State B. Trustee, a corporate trustee, is the current trustee. Trustee seeks to modify the method of determining Trust income, as authorized by and in accordance with State B Statute. Under the proposal, Paragraph SIXTH (a) and (b) will provide that the annual distribution amount to be paid by the trustees (during the Trust term) is to be an amount equal to y percent of Trust's total value, as determined on the first day of each year, *i.e.*, a y percent unitrust amount.

Trustee also seeks to provide an ordering rule for determining the character of annual Trust distributions, for income tax purposes, in accordance with State B Statute. Under the ordering rule, distribution amounts made from Trust will be considered paid from the following sources in order of priority: (1) from net accounting income determined as if Trust were not a unitrust, (2) from ordinary income not allocable to net accounting income, (3) from net realized short-term capital gain and then from net realized long-term capital gain, and (4) from principal.

In all other respects, the terms of Trust will be identical to those of the original Trust. It is represented that no additions or contributions have been made to Trust after September 25, 1985.

Presently, Daughter, Grandchild 2, and Grandchild 3 are deceased. Grandchild 2 is survived by three children (GGC 1, GGC 2, and GGC 3). Grandchild 3 died without issue. Grandchild 1 is living and has no issue.

You have asked us to rule that the modification of the method of determining Trust income and the adoption of an ordering rule, as proposed, will not cause Trust to lose its exempt status for GST tax purposes under § 2601.

LAW AND ANALYSIS

Section 2601 of the Code imposes a tax on every GST, which is defined under § 2611 as a taxable distribution, a taxable termination, and a direct skip.

Under § 1433 of the Tax Reform Act of 1986 (the Act), 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) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, except to the extent the transfer is made out of corpus added to the trust by an actual or constructive addition after September 25, 1985.

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 GST tax 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. Thus (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 paragraph (b)(4)(i)(A), (B), or (C) of this section) 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 § 26.2601-1(b)(4)(i)(D), 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.

Section 26.2601-1(b)(4)(i)(E), *Example 10*, considers the following situation. In 1980, Grantor established an irrevocable trust for the benefit of Grantor's issue, naming a bank and five other individuals as trustees. In 2002, the appropriate local court approves a modification of the trust that decreases the number of trustees which results in lower administrative costs. *Example 10* concludes that the modification pertains to the administration of the trust and 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. 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.

Section 26.2601-1(b)(4)(i)(E), *Example 11*, considers the following situation. 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. For GST tax purposes, *Example 11* concludes that 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 Code. This conclusion would be the same if the beneficiaries' consent was not required, or, if the change in administration 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.

Section 1.643(b)-1 of the Income Tax Regulations provides, in part, that "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. 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. 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. A switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of § 1001 and may result in taxable gifts from the trust's grantor and beneficiaries, based on the relevant facts and circumstances. This section is effective for taxable years of trusts and estates ending after January 2, 2004.

Under State B Statute, a trustee, other than an interested trustee may, in its sole discretion and without the approval of State B Court, convert an income trust to a total return unitrust, reconvert a total return unitrust to an income trust, or change the percentage used to calculate the unitrust amount in a total return unitrust. A "total return unitrust" is defined as an income trust that has been converted under State B Statute or the laws of any other jurisdiction that permits an income trust to be converted to a trust in which a unitrust amount is treated as the net income of the trust. State B Statute further provides that the percentage to be used in determining the unitrust amount shall be a reasonable current return from the trust, in any event not less than 3 percent nor more than 5 percent of the fair market value of the trust. The fair market value of the trust shall be determined at least annually, using such valuation date or dates or averages of valuation dates as are deemed appropriate. State B Statute further provides that the trustee shall consider the unitrust amount as paid first from net accounting income determined as if the trust were not a unitrust, then as paid from ordinary income not allocable to net accounting income, then as paid from net short-term capital gain and then from net long-term capital gain, and finally as coming from trust principal. State B Statute provides that it shall be construed as pertaining to the administration of a trust.

In this case, Trustee proposes to switch methods of determining Trust income. Under the proposed method, the annual distribution amount will be a unitrust amount of y percent of Trust's total value, which is an amount no less than 3 percent and no more than 5 percent of the trust assets. The administration of Trust as proposed is specifically authorized by and in conformance with State B Statute (the applicable local law), which provides for a reasonable apportionment between the income and remainder beneficiaries and otherwise meets the requirements of § 1.643(b)-1. Accordingly, under § 26.2601-1(b)(4)(i)(D)(2), we conclude that the administration of Trust using the proposed method of determining Trust income will not be considered to shift a beneficial interest in the trust for GST tax purposes. See § 26.2601-1(b)(4)(i)(E), *Example 11*. Furthermore, we conclude that the proposed ordering rule, which is administrative in nature and specifically applies to trusts administered under State B Statute, will not shift a beneficial interest 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. See § 26.2601-1(b)(4)(i)(E), *Example 10*. Additionally, neither the switch in methods of determining trust income nor the adoption of the

proposed ordering rule will extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Accordingly, we conclude that the modification of the method of determining Trust income and the adoption of an ordering rule, as proposed, will not cause Trust to lose its exempt status for GST tax purposes under § 2601.

Except as expressly provided herein, no opinion is implied or expressed concerning the federal tax consequences of any aspect of any transaction or item discussed or referenced in this letter. We are not ruling with regard to any gift tax or income tax consequences of the proposed modification and administration of Trust.

This ruling is directed only to the taxpayers 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 representatives.

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 rulings, it is subject to verification on examination.

Sincerely,

Karlene M. Lesho

Karlene M. Lesho
Senior Technician Reviewer, Branch 4
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures:

Copy for § 6110 purposes
Copy of this letter

cc: