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Person To Contact:

Telephone Number:

Refer Reply To:

CC:PSI:B04 – PLR-154516-02

Date: APRIL 26, 2004

In Re:

Legend:

Trustor	=
Trust	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
<u>a</u>	=
<u>b</u>	=
Court	=
Grandchild 1	=
Grandchild 2	=
Grandchild 3	=

Dear _____ :

This is in response to your June 12, 2003 letter and other correspondence requesting a ruling concerning the income, gift, and generation-skipping transfer (GST) tax consequences of the proposed settlement.

You have requested the following rulings:

1. The proposed settlement of bona fide administrative issues and the judicial construction of the Trust will not cause the Trust to lose its exempt status for GST tax purposes under section 1433(b)(2)(A) of the Tax Reform Act of 1986.
2. The proposed settlement of bona fide administrative issues and the judicial construction of the Trust will not cause a taxable gift to be made by any beneficiary under section 2501 of the Internal Revenue Code.

3. The modification of the Trust will not cause any beneficiary, nor the trust, to recognize any gain or loss from a sale or other disposition of the property under section 61 or 1001.

The facts submitted are as follows:

Trustor established Trust on Date 1. By means of a trust indenture, Trustor amended the Trust on Date 2. Trustor died and Trust became irrevocable on Date 3 (before September 25, 1985).

Paragraph 10(b) of Trust provides that upon Trustor's death, after payment of certain specific bequests, the Trustee shall hold the remainder of the trust property less taxes and other obligations of the Trustor in a continuing trust. The Trustee shall pay a of the net income of the trust to each of Trustor's children, and the remaining a to the grandchildren in equal shares. In the event that any or all of the Trustor's children shall not survive the Trustor, or in any event upon their death, the a share of the net income of the trust shall then become subject to distribution by the Trustee in its sole discretion among the surviving Trustor's children, grandchildren, and great-grandchildren in such amounts as the Trustee deems prudent. The Trustee may also from time to time accumulate all or any part of the income for any of the persons to the extent that such accumulation is allowed by law and as the Trustee deems advisable. Any income so accumulated as authorized by this paragraph may be added to principal and if so added shall thereafter be treated as principal and not as income. The Trustee shall have the right at any time and from time to time to exclude any beneficiary above designated from any distribution of income among the so designated beneficiaries and to make unequal distributions of income among the designated beneficiaries. The Trustee may also pay such portions of principal to the children or grandchildren or great-grandchildren as it may in its sole discretion determine to be in their best interests.

Paragraph 10(b) also provides that following the death of a child, the Trustee shall have the right in its sole discretion to continue to pay prudent amounts of income to and for the benefit of a surviving spouse of child. The Trustee shall in its sole discretion be entitled to distribute reasonable amounts of principal to such spouses if such should become necessary in properly maintaining and supporting them. This trust shall terminate upon the death of the survivor of Trustor's children and grandchildren living at the date of her death and the balance then on hand shall be distributed to the great-grandchildren per stirpes.

No addition has been made to the Trust since Trustor's death. All Trust income has been distributed during each year since Trustor's death. Trustor's last surviving child died on Date 4. Trustor had three grandchildren, Grandchild 1, Grandchild 2, and Grandchild 3, each of whom are still living.

The Trustee believes that the Trust is ambiguous regarding whether the Trustee's authority to accumulate income, make unequal distributions, and exclude any beneficiary from distributions affects the grandchildren's interests in the Trust income, or applies only to all other distributions from the Trust. Also, the trustee believes that the language of the Trust creates an ambiguity whether the Trust remainder is to be distributed among the great-grandchildren by right of representation or in equal shares.

The Trustee petitioned Court for an order instructing Trustee as to the administration of the Trust on three related issues:

- (i) Do the grandchildren have a vested interest in a of the Trust income?
- (ii) May the Trustee pay to the beneficiaries a unitrust amount equal to b% of the value of the Trust during each year, to be paid from income and, to the extent that income is insufficient, from the principal of the Trust?
- (iii) Is each great-grandchild entitled to an equal portion of the remainder, upon the ultimate distribution of the Trust?

The Trust beneficiaries, consisting of the grandchildren, great-grandchildren, and a court-appointed guardian ad litem representing the unascertained Trust beneficiaries, entered into an Agreement for Adjudicated Compromise (Agreement) with the Trustee, executed by the interested parties in counterparts between Date 5 and Date 6. On Date 7, the Court issued an Order which (i) found that the interpretation of the Trust instrument posed issues involving reasonable doubt, and (ii) approved the terms of the Agreement.

Section 3 of the Agreement provides that Trust continues until the death of the survivor of Trustor's grandchildren. During this time, income and principal is distributed among the grandchildren and great-grandchildren. Distributions will not, during the term of the trust, be paid to more remote descendants, or to any person other than a grandchild or great-grandchild. The Trustee will, throughout the term of the trust, distribute income and principal in the manner provided by this section.

Section 3.1 provides that the Trustee will, during each year, distribute a Unitrust amount equal to the greater of a of the trust income, or b% of the value of the trust property.

Section 3.2 provides that the Unitrust amount will be divided into three equal shares, allocating one share for each of the grandchildren (whether living or deceased). Each share will consist of a pro rata portion of each item of income and corpus comprising the Unitrust Amount. Distributions to a grandchild [or to the children of the grandchild] will be charged exclusively against the share which is set aside for that grandchild. Each share will be distributed in the following manner:

First, to the grandchild, the greater of (i) a of the trust accounting income, or (ii) a of the unitrust amount which is allocated to the respective share;

Second, to the grandchild, all or such portion of her remaining share of the Unitrust Amount as the Trustee considers appropriate to provide for the comfort and reasonable desires of the grandchild; and

Last, to the extent the Unitrust Amount is not exhausted by payment to the grandchild, the balance of the share will be distributed among the then living children of the grandchild in the manner provided by section 3.4(iii).

Section 3.3 provides that following the death of a grandchild, the Trustee will allocate a of the accrued and undistributed income, determined as of the grandchild's death, among the separate shares. The income allocated the deceased grandchild's share will be distributed to the estate of the deceased grandchild. The balance of the allocated Unitrust Amount for the period in which the grandchild's death occurs, and the Unitrust Amount which is allocated to the share throughout the remaining term of the trust, will be distributed among the then living children of the deceased grandchild in the manner provided by section 3.4(iii). If all great-grandchildren who are eligible to participate in distributions from a share have died, that share of the Unitrust Amount will be allocated to the other share(s) throughout the remaining term of the trust.

Section 3.4 provides that Distributions of the Unitrust Amount to great-grandchildren, whether during or after the life of the respective parent - (i) will be paid exclusively from the share which is set aside for the parent of the respective great-grandchild; (ii) will be paid only to those great-grandchildren who are living at the time the distribution is made; and (iii) will be in the proportions and relative amounts which the Trustee, in its discretion, considers to be in the best interests of the distributee. The amount distributed to a great-grandchild may differ from that distributed to his sibling(s), and the Trustee may exclude any great-grandchild from participating in one or more distributions.

Section 3.5 provides, in part, that in addition to distribution of the Unitrust Amount, the Trustee may from time to time distribute principal to a grandchild or great-grandchild of Trustor if the Trustee considers the distribution to be in the best interest of the distributee [as authorized by Paragraph 10(b) of the Trust instrument].

Section 4 provides that upon the death of the survivor of Grandchild 1, Grandchild 2, and Grandchild 3, and after having set aside the accrued and undistributed income payable the deceased grandchild's estate, the remaining trust property will be divided and distributed among the great-grandchildren in equal shares. The descendants of a deceased great-grandchild will take, by representation, the share to which their deceased parent would have been entitled. If a deceased great-grandchild has no then living descendant, that share will lapse and be added to

the shares of the remaining great-grandchildren (and descendants of those who are deceased).

The Order further states that the Trustee is instructed to implement the foregoing provisions upon receipt of a ruling issued by the Internal Revenue Service which determines that compliance with the provisions of the Agreement will not result in adverse GST consequences.

LAW AND ANALYSIS

Ruling 1

Section 2601 imposes a tax on every generation-skipping transfer. The term "generation-skipping transfer" is defined in section 2611 as a taxable distribution, a taxable termination, or a direct skip.

Under section 1433(a) of the Tax Reform Act of 1986 (Act) and section 26.2601-1(a) of the Generation-Skipping Transfer Tax Regulations, the GST is generally applicable to generation-skipping transfers made after October 22, 1986. However, under section 1433(b)(2)(A) of the Act and section 26.2601-1(b)(1)(i), the GST 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). Under section 26.2601-1(b) will not cause the trust to lose its exempt status.

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 will not cause the trust to lose its exempt status.

Section 26.2601-1(b)(4)(i)(C) provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to be subject to the provisions of chapter 13, if (1) the judicial action involves a bona fide issue, and (2) the construction is consistent with applicable state law that would be applied by the highest court of the state.

Section 26.2601-1(b)(4)(i)(D) provides that a modification of the governing instrument of an exempt trust (including a construction that does not satisfy section 26.2601-1(b)(4)(i)(C)) will not cause an exempt trust to be subject to the GST tax if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 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 generation-skipping transfer or the creation of a new generation-skipping transfer. A modification that is administrative in nature that only indirectly increases the amount transferred will not be considered to shift a beneficial interest in the trust.

Section 26.2601-1(b)(4)(i)(E), Example 3 considers a situation where, in 1980, Grantor established an irrevocable trust for the benefit of Grantor's children, A and B, and their issue. The trust is to terminate on the death of the last to die of A and B, at which time the principal is to be distributed to their issue. However, the provision governing the termination of the trust is ambiguous regarding whether the trust principal is to be distributed per stirpes, only to the children of A and B, or per capita among the children, grandchildren, and more remote issue of A and B. In 2002, the trustee files a construction suit with the appropriate local court to resolve the ambiguity. The court issues an order construing the instrument to provide for per capita distributions to the children, grandchildren, and more remote issue of A and B living at the time the trust terminates. The court's construction resolves a bona fide issue regarding the proper interpretation of the instrument and is consistent with applicable state law as it would be interpreted by the highest court of the state. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

Section 26.2601-1(b)(4)(i)(E), Example 8 considers a situation where, in 1980, Grantor established an irrevocable trust under the terms of which 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 appropriate local court approves a modification to the trust that converts A's income interest into the right to receive the greater of the entire income of the trust or a fixed percentage of the trust assets valued annually (unitrust interest) to be paid each year to A for life. The modification does not result in a shift in beneficial interest to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. In this case, the modification can only operate to increase the amount distributable to A and decrease the amount distributable to A's issue. 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 of the Internal Revenue Code.

In this case, the Order will clarify the ambiguous language of the Trust. The Order will also modify the distribution of income and principal provisions and distribute unitrust interests to Trustor's grandchildren. These actions will not result in a shift of any beneficial interest to any beneficiary who occupies a generation lower than the persons holding the beneficial interests. Further, the proposed actions will not extend the time for vesting of any beneficial interest in Trust. Accordingly, based on the facts submitted and representations made, we conclude that the proposed settlement of bona fide administrative issues and the judicial construction of ambiguous language of the Trust will not cause the Trust to lose its exempt status for GST purposes.

Ruling 2

Section 2501 imposes a tax for each calendar year on the transfer of property by gift by an individual. Section 2511 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 25.2511-1(h)(6) of the Gift Tax Regulations describes a situation in which the transfer of a vested remainder interest was subject to the gift tax. That example provides as follows:

If A is possessed of a vested remainder interest in property, subject to being divested only in the event he should fail to survive one or more individuals or the happening of some other event, an irrevocable assignment of all or any part of his interest would result in a transfer includible for Federal gift tax purposes.

In this case, no “transfer” of a beneficial interest in the Trust, or of a part of a beneficial interest in the Trust, has occurred as a result of the execution of the Agreement or the issuance of the Order. The Agreement and Order represent a mutual understanding that clarifies and defines the interests that each of the beneficiaries received from the Trustor at the time that the Trust became irrevocable. Accordingly, based on the facts submitted and representations made, we conclude that the proposed settlement of bona fide administrative issues and the judicial construction of ambiguous language of the Trust will not cause a taxable gift to be made by any beneficiary under section 2501.

Ruling 3

Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in section 1011 for determining loss over the amount realized. Under section 1001(c), the entire amount of gain or loss must be recognized, except as otherwise provided.

Section 1.1001-1(a) of the Income Tax Regulations provides that except as otherwise provided in subtitle A of the Code, the gain or loss realized from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

An exchange of property results in the realization of gain or loss under section 1001 if the properties exchanged are materially different. Cottage Savings Ass’n 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 Court held that mortgage loans made to different obligors and secured by different homes did embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interest in the loans. Id. at 566. In defining what constitutes a “material difference” for purposes of section 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.

In this case, the modification of the discretionary income trust to a unitrust, pursuant to the Court order issued Date 7, and the other provisions in the Court order do not result in a material difference in the legal entitlements enjoyed by the beneficiaries of the trust. Under the terms of the Trust, the trustee had discretion to pay portions of principal to the grandchildren. Under the unitrust, the beneficiaries now have a right to a fixed amount of principal in the event the yearly income is not large enough. The grandchildren are still only entitled to share equally in the a share of the income. Accordingly, we conclude that no gain or loss is recognized as a result of the modification of the trust for purposes of section 1001(a).

In accordance with the Power of Attorney on file with this office, copies of this letter are being sent to your authorized representative.

Except as expressly provided herein, no opinion is expressed or implied concerning the 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) of provides that it may not be used or cited as precedent.

Sincerely yours,

Lorraine E. Gardner
Senior Counsel, Branch 4
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure:

Copy of letter for section 6110 purposes