

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact:

Telephone Number:

Refer Reply To:

CC:PSI:B04 – PLR-102993-04

Date: JULY 15, 2004

In Re:

LEGEND:

Grantor	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Son 1	=
Son 2	=
Son 3	=
County Court	=
Probate Court	=
Grandchild 1	=
Grandchild 2	=
Grandchild 3	=
Grandchild 4	=
Grandchild 5	=
Grandchild 6	=
Trust	=
Trust 1	=
Trust 2	=
Trust 3	=
Trust 4	=
Trust 5	=
Trust 6	=
<u>a</u>	=

Dear _____ :

This is in response to your January 7, 2004 letter and other correspondence requesting a ruling concerning the generation-skipping transfer (GST) tax consequences of a proposed conversion of a trust.

You have requested the following ruling:

The proposed conversion of Trust from an income-only trust to a total return trust will not cause distributions from or termination of the Trust to become subject to the GST tax under section 2601 of the Internal Revenue Code.

The facts submitted are as follows:

Grantor executed Trust, a revocable trust on Date 1. Trust was amended on Date 2 and Date 3. Grantor died on Date 4 (before September 25, 1985) and Trust became irrevocable.

Paragraph 9 of Trust provides that net income not distributed by other provisions of Trust shall be accumulated as part of the corpus until such time after the death of Grantor and Grantor's wife, as his oldest surviving grandchild attains the age of 28 years, or 20 years and 11 months after the death of the last survivor of Grantor's lineal descendants living at the time of his death, whichever shall be the first to occur. Thereupon, the corpus of Trust shall be divided into as many parts as the Grantor shall then have living sons and deceased sons with surviving children, and continue to hold one of said parts as a separate trust for the children or prospective children of each of Grantor's living sons and the lineal descendants of each of Grantor's deceased sons, per stirpes and not per capita. The trustee shall accumulate the net income on each of these trusts in an income account until distributed as follows: As each lineal descendant of a son attains the age of 28 years, he or she shall be paid his or her full pro rata share of the accumulated income, per stirpes and not per capita, and thereafter be paid his or her pro rata share of the current income in convenient periodic installments until said trust is terminated.

Paragraph 9 also provides the following termination provisions: Twenty years and 11 months after the death of the Grantor's last lineal descendant, who shall have been living at the time of the Grantor's death, these trusts in their entirety shall immediately cease and terminate. Upon such termination, the corpus held for the children of each of Grantor's sons shall be forthwith paid over to the lineal descendants of such son, share and share alike, per stirpes and not per capita. At the same time any undistributed income shall be paid over to those who would have been entitled thereto had they already attained the age of 28 years. Should any son die without leaving any surviving lineal descendant, or should the last surviving lineal descendant of any son die before final distribution, the share of corpus set aside for the children or possible

children of such son, and any accumulated income thereon, shall be equally divided and added to the corpus of the shares being held as trusts for the children of the Grantor's remaining sons and shall be held and distributed in the same manner as if it had been originally a part of the corpus of such trusts. Anything herein to the contrary notwithstanding, the trustee may, in its sole discretion, in cases of emergency, the existence of which the trustee shall be the sole judge, make an advance or advances to any lineal descendant of the Grantor in such amount or amounts as the trustee deems advisable. Records shall be kept of all such advances to the end that they may be equalized, either out of future income, or upon final distribution, as the trustee in its judgment may deem best.

Grantor had three sons: Son 1, Son 2, and Son 3. Son 1's only child is Grandchild 1. Son 2's children are Grandchildren 2 and 3. Son 3's children are Grandchildren 4, 5, and 6.

Grantor's wife died on Date 5. Pursuant to Paragraph 9 and the Date 6 order of County Court, Trust was divided into three separate trust shares for Son 1, Son 2, and Son 3. County Court's order also authorized the trustee, in its discretion, to subdivide any one-third trust share into separate trust shares for the grandchildren or more remote descendants and to pay each beneficiary's educational expenses from his or her respective share, if the trustee deems such a subdivision to be advisable. Pursuant to that order: (i) the trust for Son 1 is held for the benefit of Grandchild 1; (ii) the trust for Son 2 was divided into two trusts, Trusts 2 and 3, for the benefit of Grandchildren 2 and 3, respectively; and (iii) the trust for Son 3 was divided into three trusts, Trusts 4, 5, and 6, for the benefit of Grandchildren 4, 5, and 6, respectively.

On Date 7, the trustee petitioned Probate Court to reform Trust. Pursuant to the proposed reformation:

Paragraph 9 of Trust will provide, in relevant part, that the trustee shall pay, distribute, or disburse, to or for the benefit of said grandchild an amount equal to a% of the average of the fair market value of the grandchild's share as of the close of the last business day of the Trust's three previous years, or the net income, whichever is greater and is hereinafter referred to as the "distribution amount."

Paragraph 9, section a, will provide that all computations of the Trust's fair market value shall include accounting income and principal, but no accruals shall be required. If the Trust includes assets for which there is not a ready market, the Trustee shall adopt a method of evaluation as the Trustee deems reasonable in its discretion under the circumstances.

Paragraph 9, section b, will provide that the distribution amount from the Trust shall be paid first from net income, next from net realized short-term capital

gains, then from net realized long-term capital gains, and as necessary, from the principal of Trust.

Paragraph 9, section e, will provide, in pertinent part, that the Corporate Trustee shall have the discretion to modify the a% distribution rate as trustee may deem necessary, with the approval of the Probate Court or such other court as in the future may have jurisdiction over this Trust. Such a change in rate shall be within the power of the Court to approve, based upon the request for approval of the Corporate Trustee, given the instrument and distribution goals of this Trust. No individual trustee shall have such power.

Paragraph 9, section f, will provide that the distribution amount shall be paid in convenient installments until said trust is terminated.

The termination provisions of Paragraph 9 remain unchanged.

On Date 8, Probate Court ordered that Trust be reformed, pending a favorable letter ruling from the Internal Revenue Service.

LAW AND ANALYSIS

Section 2601 of the Internal Revenue Code imposes a tax on every generation-skipping transfer (GST), which is defined under section 2611 as a taxable distribution, a taxable termination, or a direct skip.

Under section 1433 of the Tax Reform Act of 1986 (the Act), GST tax 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) 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)(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 generation-skipping transfer tax under section 26.2601-1(b) will not cause the trust to lose its exempt status. These rules are applicable only for purposes of determining whether an exempt trust retains exempt status for generation-skipping transfer tax purposes. 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 section 1001.

Section 26.2601-1(b)(4)(i)(D) provides that a modification 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 a 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.

Section 26.2601-1(b)(4)(i)(E), Example 8, illustrates a situation where a trust that is otherwise exempt from the GST tax 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, 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 example concludes that 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. Rather, 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 modification will not subject the trust to the provisions of chapter 13.

In this case, the proposed modification of Trust to provide for the distribution to grandchild an amount equal to a% of the average of the fair market value of the grandchild's share as of the close of the last business day of the Trust's three previous years, or the net income, whichever is greater, does not result in a shift of any beneficial interest in Trust to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the modification. See section 26.2601-1(b)(4)(i)(E), Example 8. Further, the modification does not extend the time for vesting of any beneficial interest in Trust beyond the period provided for in the original Trust.

Accordingly, based on the facts submitted and the representations made, we conclude that the proposed conversion of Trust from an income-only trust to a total return trust will not cause distributions from or termination of the Trust to become subject to the GST tax under section 2601.

In accordance with the Power of Attorney on file with this office, a copy of this letter is 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. We are specifically not ruling on the gift tax and income tax consequences of the transaction.

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 requesting it. Section 6110(k)(3) of the Code 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