

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200609003**

Release Date: 3/3/2006

Index Number: 2601.04-01, 1001.00-00,
2501.00-00

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact: _____, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B09
PLR-128189-05

Date:
November 21, 2005

LEGEND

- Date 1 =
- Settlor =
- Company =
- Daughter =
- Wife =
- Trust 1 =
- Date 2 =
- Date 3 =
- State Court =

- Trust 2 =
- Foundation =
- State =
- Date 4 =
- Date 5 =
- State Unitrust Statute =

Dear _____ :

This is in response to your authorized representative's letter dated May 9, 2005, requesting rulings regarding the income, gift, and generation-skipping transfer (GST) tax consequences of a modification of a trust.

The facts and representations are as follows: On Date 1, a date prior to September 25, 1985, Settlor entered into a trust agreement that established five separate trusts. The five trusts were formed primarily for the purpose of holding stock in

Company. One of the five separate trusts was created for the benefit of Settlor's Daughter ("Daughter") and another of the five trusts was created for the benefit of Settlor's Wife ("Wife"). The trust created for the benefit of Daughter is referred to herein as Trust 1.

Wife died on Date 2. On Date 3, State Court partitioned Wife's trust and ordered that fifty percent of the trust assets be distributed to a separate trust for the benefit of Daughter ("Trust 2").

Article I of each trust provides generally that the trusts will terminate thirty years after the death of the last survivor of a class that includes Wife, Daughter, and five other individuals.

Article X of each trust creates an income interest in Daughter during her lifetime, and after her death, in Daughter's issue. If at any time after the death of Daughter there are no issue of Daughter surviving, then fifty percent of the income that such deceased issue would have received shall be paid to the spouse(s), if any, of such deceased issue. There is no provision for distribution of principal.

Article XI of each trust provides that upon the termination of a trust, the remaining assets shall be distributed to Daughter's issue. In the event that no issue of Daughter is surviving at the termination of each trust, fifty percent of the trust assets shall be paid to Foundation and fifty percent of the trust assets shall be paid to the living spouse(s), if any, of Daughter's deceased issue.

Article XVII of each trust provides that the trusts are irrevocable.

Article XX of each trust provides that the situs of the trusts is State.

Daughter died on Date 4. However, Trust 1 and Trust 2 have not terminated because several members of the class defined in Article I of the trusts are still alive.

On Date 5, State enacted new legislation that revised State's Principal and Income Act. The new legislation includes specific provisions authorizing trustees to make equitable adjustments between trust income and principal and convert eligible trusts to unitrusts for purposes of defining trust income.

State Unitrust Statute, which was enacted on Date 5 as part of the new legislation described above, authorizes a trust to be converted to a unitrust by court order if the trustee or beneficiary has provided statutory notice of the intention to convert the trust to a unitrust, and the notice advises how the unitrust will operate, including the fixed percentage and any other initial determinations that will be requested, and the court determines that the conversion to a unitrust will enable the trustee to better carry out the purposes of the trust. State Unitrust Statute further provides that if a trust is

converted to a unitrust pursuant to a court order, the court shall determine the fixed percentage to be applied to the trust.

The trustees of Trust 1 and Trust 2 intend to petition State Court for an order converting the income interests in Trust 1 and Trust 2 into unitrust interests. Pursuant to State Unitrust Statute, the trustees will seek to determine the income of the trusts for the current calendar year and future years as a fixed percentage of the net fair market value of each trust's assets. The fixed percentage will be determined by the court. The trustees will request that the fixed percentage be set between 3% and 5% of the net fair market value of each trust's assets, with such value averaged over a period between three and five years as determined by the court. The conversion of the income interests in Trust 1 and Trust 2 into unitrust interests will be contingent upon the issuance of a favorable private letter ruling.

You have requested the following rulings:

1. The conversion of Trust 1 and Trust 2 into unitrusts under State Unitrust Statute will not cause Trust 1 and Trust 2 to lose their grandfathered status from GST tax.
2. The conversion of Trust 1 and Trust 2 into unitrusts under State Unitrust Statute will not cause Trust 1, Trust 2, or any beneficiary to have made a gift for gift tax purposes.
3. The conversion of Trust 1 and Trust 2 into unitrusts under State Unitrust Statute will not cause Trust 1, Trust 2, or any beneficiary to realize capital gains from an exchange of a trust interest for income tax purposes.

RULINGS 1 and 2

Section 2501 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 GST 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 2631(a) provides that for purposes of determining the inclusion ratio, every individual shall be allowed a GST exemption of \$1,000,000 which may be allocated by such individual (or his executor) to any property with respect to which such individual is the transferor.

Section 2632(c)(1) provides that any portion of an individual's GST exemption that has not been allocated within the time prescribed by § 2632(a) shall be deemed to be allocated as follows – (A) first, to property that is the subject of a direct skip occurring at such individual's death, and (B) second, to trusts with respect to which such individual is the transferor and from which a taxable distribution or a taxable termination might occur at or after such individual's death.

Section 26.2601-1(b)(1)(ii)(A) provides, generally, that any trust in existence on September 25, 1985, will be considered an irrevocable trust unless otherwise provided in § 26.2601-1(b)(ii)(B) or (C), relating 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. 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. 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 § 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) 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 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.

Section 26.2601-1(b)(4)(i)(E), Example 11, considers 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. 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 the 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.

In this case, Trust 1 and Trust 2 (by virtue of the fact that Trust 2 was formed after the partition of Wife's trust) were irrevocable on September 25, 1985, and there were no additions to the trusts after September 25, 1985.

In addition, 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 Unitrust 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 will not be considered to shift any beneficial interest in the trusts and, therefore, will not cause either trust to lose its exempt status for GST purposes. We further conclude that the proposed modification 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) provides that gross income includes gains derived from dealings in property. Under §1.61-1(a) of the Income Tax Regulations, 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.

Under §1001(a), 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), 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(a) of the Income Tax Regulations provides that the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or loss sustained.

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, it is not taken into account.

Under State Unitrust Statute, a judicial conversion to a unitrust 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 Example 11 of § 26.2601-1(b)(4)(i)(E), an income trust was converted to a unitrust under a state statute authorizing such conversions. The example concludes that “neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes.” Therefore, provided the proposed conversion meets the requirements of State Unitrust Statute and an order from the Court approving the conversion is obtained, no gain or loss will be recognized under § 61 or §1001 by Trust 1, Trust 2, or any beneficiary of Trust 1 or Trust 2 as a result of the proposed modifications.

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.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) 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 representative.

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.

Sincerely,

Melissa C. Liquerman
Branch Chief
(Passthroughs & Special Industries)

Enclosure
Copy for 6110 purposes

cc: