

## Internal Revenue Service

Number: **200627005**

Release Date: 7/7/2006

Index Number: 2601.03-01

Department of the Treasury  
Washington, DC 20224

Third Party Communication: None  
Date of Communication: Not Applicable

Person To Contact:  
, ID No.

Telephone Number:

Refer Reply To:  
CC:PSI:B09  
PLR-135032-05

Date:  
March 28, 2006

### Legend

Decedent =  
Date 1 =  
Date 2 =  
Trust =

Child 1 =  
Child 2 =  
Date 3 =  
State =  
Court =

Dear :

This is in response to your representative's letter, dated June 23, 2005, and subsequent correspondence requesting rulings regarding the income, gift, and generation-skipping transfer (GST) tax consequences of the proposed construction of a trust agreement.

### Facts

Decedent executed his last will and testament on Date 1 and died on Date 2. Decedent's will provides for a number of specific bequests, and further provides that the residue of the estate is to pass to Trust. Pursuant to the terms of the will, Trust was divided into two shares, Share A and Share B, one for the benefit of each of Grantor's children and their children.

Date 1 and Date 2 are prior to September 25, 1985. The trustee represents that there have been no additions, actual or constructive, to Trust after September 25, 1985.

Share A is for the benefit Child 1 and her children. The terms that govern Share A provide that during Child 1's life, Child 1 receives 2/3 of the net income and her children receive 1/3 of the income. The trustee does not have the authority to invade corpus for the benefit of any beneficiary. At Child 1's death, all the income is payable to Child 1's surviving issue per stirpes. If Child 1 and all of her issue die before the Trust terminates, the entire assets of Share A are to be added to the assets of Share B.

The terms that govern Share B are identical to Share A, except that Share B is to be held for the benefit of Child 2 and his children. Child 2 died on Date 3, without issue. According to the terms of Decedent's will, Share A and Share B were combined as of Child 2's death.

State law allows for the adjustment of a trust income interest to a total return unitrust interest. As a result of the enactment of the state statute, the trustee and each of the beneficiaries will petition Court to grant a modification to provide that until Child 1's death, the trustee will pay 2/3 of a 5 percent unitrust amount to Child 1 and 1/3 of the unitrust amount per stirpes to Child 1's then living issue.

After Child 1's death, the entire unitrust amount will be paid to Child 1's surviving issue per stirpes. Upon the death of the last surviving income beneficiary, the trustee will distribute all of the remaining assets of the trust as set forth under the terms of Decedent's will.

### Rulings Requested

The trustees have requested rulings that the proposed modification of Trust under State law: (1) will not affect the GST tax exempt status of Trust under §26.2601-1(b)(1); (2) will not be considered a sale, exchange, or other disposition of property and will not cause Trust or any of the beneficiaries to realize a gain or loss for purposes of § 1001; and (3) will not cause a transfer, direct or indirect, of property that will be subject to the gift tax imposed by § 2501.

### Ruling 1

Section 2601 imposes a tax on every generation-skipping transfer.

Section 2611(a) defines the term "generation-skipping transfer" to include a taxable distribution, taxable termination, and a direct skip.

In this case, Trust is a GST trust because it provides for distributions to more than one generation of beneficiaries below the grantor's generation. 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 generation-skipping transfer under a trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985, but only to the extent that the transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added).

Section 26.2601-1(b)(1)(ii)(A) provides that any trust in existence on September 25, 1985, is considered an irrevocable trust except as provided in §§ 26.2601-1(b)(ii)(B) or (C), that relate to property includible in a grantor's gross estate under §§ 2038 and 2042. In the present case, Trust is considered to have been irrevocable on September 25, 1985, because neither § 2038 nor § 2042 applies.

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. In general, unless specifically provided for 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 generation-skipping transfer 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 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) 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 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

person 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.

Section 26.2601-1(b)(4)(i)(E), Example 11 illustrates the application of paragraph (b)(4). In that case, Grantor, a resident of State X, established an irrevocable trust in 1980 for the benefit of Grantor's child, A, and A's issue. Under the terms of the 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 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 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.

In the present case, proposed modification of Trust in accordance with State law will 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. Furthermore, the proposed modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. See § 26.2601-1(b)(4)(i)(E), Example 11. Accordingly, proposed modification under State law will not cause Trust to lose its status as exempt from the GST tax.

### Ruling 2

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 § 1011 for determining loss over the amount realized. Under § 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 § 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 § 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 proposed modification of Trust by mere exercise of the trustee's authority to make the conversion under a State statute is not a sale or exchange of a materially different interest by any beneficiary. Accordingly, based on the facts submitted and the representations made and provided the proposed conversion meets the requirements of the applicable State statute, we conclude that no gain or loss will be recognized under § 61 or § 1001 by Trust or any beneficiary of Trust as a result of the proposed modifications.

### Ruling 3

Section 2501 imposes a tax on the transfer of property by gift by an individual. Section 2502(c) provides that the payment of the gift tax is the liability of the donor.

Section 2511 provides that the tax imposed by § 2501 shall 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.

Section 2512(a) provides that, where property is transferred for less than adequate and full consideration in money or money's worth, the amount by which the value of the property exceeds the value of the consideration is deemed a gift.

Section 25.2511-2(a) provides that the gift tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.

In this case, because the proposed modification of Trust does not change the interests of the beneficiaries, no transfer of property will be deemed to occur. See § 26.2601-1(b)(4)(i)(E), Example 11. Accordingly, we conclude that the proposed modification of Trust under State law will not cause a transfer, direct or indirect, of property that will be subject to the gift tax imposed by § 2501.

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

Pursuant to the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer's representative.

Sincerely,

James F. Hogan

James F. Hogan  
Senior Technician Reviewer, Branch 9  
(Passthroughs & Special Industries)

Enclosure

Copy for § 6110 Purposes