Internal Revenue Service

Department of the Treasury
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Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B04
PLR-139456-14

In Re:

Date:
March 16, 2015

Legend:

Decedent	=
Spouse	=
Daughter	=
Son	=
Grandson	=
Granddaughter 1	=
Granddaughter 2	=
Trust	=
State	=
State Statute	=
Trustee	=
Foundation	=
Court Order	=
PLR	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=

Dear :

This letter responds to your letter dated October 20, 2014, submitted by your authorized representative, requesting income, gift, and generation-skipping transfer

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(GST) tax rulings with respect to the proposed modification to the calculation of the Total Return Share for Trust, pursuant to State Statute.

Decedent died on Date 1 (a date prior to September 25, 1985), survived by Spouse, Daughter, Son, Grandson, Granddaughter 1, and Granddaughter 2. Decedent's will established trusts for the benefit of Daughter and Son and their issue. Paragraph (d) of Item VII of the will provides that Decedent devises the balance of the residue of his estate to Trustee to be held in trust until twenty-one (21) years after the death of the last survivor among his children and grandchildren as may be in being at the time of his death and upon termination the principal of each trust shall be divided among its income beneficiaries, *per stirpes*. Trustee shall divide said residue into two separate and equal trusts to be designated "Fund A" and "Fund B."

Paragraph d-1 of Item VII provides that Fund A shall be held by Trustee for the benefit of Daughter and her issue. Daughter shall receive two-thirds (2/3) of the net income so long as she may live, in monthly or quarterly installments as she may direct. The issue of Daughter, *per stirpes*, shall receive one-third (1/3) of the net income so long as Daughter shall live, in monthly or quarterly installments as she may direct. If all of the issue of Daughter shall predecease her, Daughter shall thereafter receive the entire net income so long as she shall live. Upon the death of Daughter or upon Decedent's death if she should predecease Decedent, Fund A shall be held for the benefit of the surviving issue of Daughter, *per stirpes*, and her issue shall receive the entire net income until the termination of this trust as set out in paragraph d of this Item VII. If any issue of Daughter should die during the life of the trust, the share of income of the deceased issue shall be paid to the then living issue of Daughter, *per stirpes*. Upon the death of Daughter without issue surviving, or upon the death of her last surviving issue prior to termination, the entire assets of Fund A in the custody of Trustee shall be added to Fund B to be held as hereinafter provided.

Paragraph d-2 of Item VII provides that Fund B shall be held by Trustee for the benefit of Son and his issue. Son shall receive the entire net income until he shall have issue in being. Thereafter, he shall receive two-thirds (2/3) of the net income so long as he may live, in monthly or quarterly installments as he may direct. The issue of Son, *per stirpes*, shall receive one-third (1/3) of the net income so long as Son shall live, in monthly or quarterly installments as he may direct. Upon the death of Son or upon Decedent's death if he should predecease Decedent, Fund B shall be held for the benefit of the surviving issue of Son, *per stirpes*, and his issue shall receive the entire net income until the termination of this trust as set out in paragraph d of this Item VII. If any issue of Son should die during the life of the trust, the share of income of the deceased issue shall be paid to the then living issue of Son, *per stirpes*. Upon the death of Son without issue surviving, or upon the death of his last surviving issue prior to termination the entire assets of Fund B in the custody of Trustee shall be added to Fund A to be held as hereinabove provided.

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Item VIII provides that if, at any time before the termination of either trust as fixed by Item VII(d), there shall be no living children of Decedent or their issue to receive the income from Fund A or Fund B, then, upon the death of the last to die among said issue, the trusts designated Fund A and Fund B shall terminate and the entire assets then in the custody of Trustee shall pass in fee to Spouse, if living, and, if not, then in fee to Foundation.

Son died a few months after Decedent on Date 2 (a date prior to September 25, 1985), leaving no issue. Pursuant to Paragraph d-2 of Item VII of Decedent's will assets allocated to Fund B were instead allocated to Fund A (hereinafter Trust).

On Date 3 (a date after September 25, 1986), Trust was converted to a unitrust pursuant to Court Order. Paragraph 1 of Court Order provides that Trust be converted to a total return share ("Total Return Share") whereby in each taxable year of the Total Return Share until Daughter's death, Trustee shall pay 2/3 of the Unitrust Amount (as hereinafter defined) to Daughter and 1/3 of the Unitrust Amount *per stirpes* to Daughter's issue, with the total unitrust amount ("Unitrust Amount") being equal to five percent of the net fair market value of the Total Return Share Assets (as hereinafter defined) valued as of the last business day of the prior taxable year. The Total Return Share shall include all of Trust's assets and shall include all subsequent acquisitions and reinvestments thereof ("Total Return Share Assets"). After Daughter's death, such Unitrust Amount shall be paid to Daughter's surviving issue *per stirpes*. The Unitrust Amount for each taxable year shall be paid to the income beneficiaries in monthly or quarterly installments, as Daughter may direct from time to time during her lifetime, or after her death, as a majority in beneficial interest of Daughter's then living issue shall from time to time direct.

Paragraph 2 of Court Order provides that upon the death of the last surviving income beneficiary, Trustee shall distribute all of the Total Return Share Assets, other than any amount then due to the last surviving income beneficiary (or his or her personal representative), in accordance with the ultimate disposition of Trust as set forth under the terms of Decedent's will.

On Date 4 (a date after September 25, 1985), the Internal Revenue Service issued PLR, which provided that the conversion of Trust to a unitrust pursuant to Court Order: (1) did not affect the GST tax exempt status of Trust under § 26.2601-1(b)(1); is not considered a sale, exchange, or other disposition of property and did not cause Trust or any of the beneficiaries to realize a gain or loss for purposes of § 1001; and (3) did not cause a transfer, direct or indirect, of property that will be subject to the gift tax imposed by § 2501.

On Date 5 (a date after September 25, 1985), Daughter died survived by her son and two daughters, Grandson, Granddaughter 1, and Granddaughter 2. Trustee

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represents that there have been no additions, actual or constructive, to Trust after September 25, 1985.

State Statue provides:

> After a trust is converted to a unitrust, all of the following provisions shall apply:
>
> 1. The fiduciary shall follow an investment policy seeking a total return for the investments held by the trust, whether the return is to be derived:
>
> a. From appreciation of principal;
>
> b. From earnings and distributions from principal; or
>
> c. From both;
>
> 2. The fiduciary shall make regular distributions in accordance with the terms of the trust, or the terms of the will, as the case may be, construed in accordance with the provisions of this section; and
>
> 3. Unless expressly prohibited by the terms of the trust, the term "income" in the terms of a trust or will means an annual distribution, the "unitrust distribution," equal to the percentage, the "payout percentage," that is no less than three percent (3%) and no more than five percent (5%) and that the fiduciary may determine in the fiduciary's discretion from time to time, or, if the fiduciary makes no determination, that shall be four percent (4%), of the net fair market value of the trust's assets, whether such assets would be considered income or principal under other provisions of this chapter, averaged over the lesser of:
>
> a. The three (3) preceding years; or
>
> b. The period which the trust has been in existence.

Trustee and the beneficiaries of Trust, pursuant to State Statute, propose to modify Trust to provide that the calculation of the Total Return Share be based on the average of the net fair market value of the Total Return Share Assets valued as of the last business day of each of the immediately preceding three taxable years rather than on the last business day of the prior taxable year.

Trustee has requested the following rulings.

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(1) The proposed modification to the calculation of the Total Return Share for Trust will not violate the transition rules under § 1433(b)(2)(A) of the Tax Reform Act of 1986 and, thus, Trust and the Total Return Share will continue to be exempt from the GST tax.

(2) The proposed modification to the calculation of the Total Return Share for Trust will not cause Trust, the Total Return Share, or any of the beneficiaries to be subject to gift tax with respect thereto.

(3) The proposed modification to the calculation of the Total Return Share for Trust will not be considered a sale, exchange, or other disposition of property and will not cause Trust, the Total Return Share, or any of the beneficiaries to realize a gain or loss for purposes of § 1001.

Law and Analysis - Rulings 1 and 2:

Section 2501(a)(1) imposes a tax for each calendar year on the transfer of property by gift during such calendar year by an individual.

Section 2511(a) provides that the tax imposed by § 2501 will 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 2601 imposes a tax on every GST. Section 2611(a) defines a GST 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 GST tax provisions do not apply to any GST under a trust 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 26.2601-1(b)(1)(ii)(A) provides that any trust in existence on September 25, 1985, will be considered an irrevocable trust except as provided in § 26.2601-1(b)(ii)(B) or (C), which relate 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 GST 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 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. Unless specifically noted, the rules do not apply in determining, for

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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 § 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 or the creation of a new GST. 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 of the Income Tax Regulations.

Section 26.2601-1(b)(4)(i)(E) Example 11, considers a situation where 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

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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. 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 trust 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.

Trustee represents that Trust was irrevocable on September 25, 1985, and that there have been no additions, constructive or otherwise, to Trust after September 25, 1985. Consequently, Trust is currently exempt from GST tax.

The facts in this case are similar to those set forth in Example 11 of § 26.2601-1(b)(4)(i)(E), which concludes 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 tax purposes. Trust already converted to a unitrust on Date 3. The proposed modification to a Total Return Share is permitted by State Statute. State Statute allows the annual unitrust payment to be determined as a percentage of the net fair market value of trust assets determined as a rolling average of the trust's three preceding taxable years. In addition, Example 11 concludes that no trust beneficiary will be treated as having made a gift for federal gift tax purposes as a result of such a conversion.

Accordingly, based upon the facts submitted and the representations made and provided the proposed modification meets the requirements of State Statute and other applicable State statutes, we conclude that the proposed modification to the calculation of the Total Return Share for Trust will not violate the transition rules under § 1433(b)(2)(A) of the Tax Reform Act of 1986 and, thus, Trust and the Total Return Share will continue to be exempt from the GST tax. We further conclude, based upon the facts submitted and the representations made and provided the proposed modification meets the requirements of State Statute and other applicable State statutes, that the proposed modification to the calculation of the Total Return Share for Trust will not cause Trust, the Total Return Share, or any of the beneficiaries to be subject to gift tax with respect thereto.

Ruling 3:

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Section 61(a)(3) provides that, except as provided in subtitle A, gross income means all income from whatever source derived, including income from dealings in property.

Section 61(a)(15) provides that gross income includes income from an interest in a trust.

Section 1.61-1(a) provides that gross income means all income from whatever source derived, unless excluded by law. Gross income includes realized in any form, whether in money, property, or services.

Section 1001(a) provides that the 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 adjusted basis provided in § 1011 for determining loss over the amount realized.

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. In determining the amount realized--(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and (2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

Section 1.1001-1(a) provides that, except as otherwise provided in subtitle A, the gain or loss realized from the conversion of property into cash, or from the exchange of property differing materially in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received.

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 interests 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.

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Section 643(b) provides, in relevant part, that for purposes of this subpart and subparts B, C, and D, the term "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law.

Section 1.643-1(b) provides, in relevant part, that for purposes of subparts A through D, part I, subchapter J, chapter 1, "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of § 642(b) (relating to the personal exemption) and § 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal. 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.

Section 1.643-1(b) further provides, in relevant part, that allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods. 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.

Trustee proposes to exercise the authority granted to Trustee under State Statute to modify the computation of the fair market value of the assets in Trust. Thus, the modification of the rights of beneficiaries to the income and principal of Trust as a result of the modification is a result of the exercise by Trustee of authority granted to Trustee under the terms of Trust and State Statute, not as a result of the exchange of their interests in Trust. The proposed modification of the Total Return Share for Trust

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by mere exercise of Trustee's authority 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 representations made and provided the proposed modification meets the requirements of State Statute and other applicable State statutes, we conclude that the proposed modification to the calculation of the Total Return Share for Trust will not be considered a sale, exchange, or other disposition of property and will not cause Trust, the Total Return Share, or any of the beneficiaries to realize a gain or loss for purposes of § 1001.

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.

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(s) 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,

Lorraine E. Gardner

Lorraine E. Gardner
Senior Counsel, Branch 4
(Passthroughs & Special Industries)

Enclosures:
Copy for section 6110 purposes

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