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Person To Contact: _____, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B09
PLR-140209-04

Date:
July 25, 2005

In Re:

Legend:

Child =
Grantor =
Spouse =
College =
Trust =

State 1 =
State 2 =
Partnership =
Statute 1 =
Statute 2 =
Date 1 =
Date 2 =
Year 1 =

Dear _____ :

This is in response to your letter dated July 15, 2004, requesting rulings on the income, gift, and generation-skipping transfer (GST) tax consequences of certain proposed modifications to a trust.

The facts submitted and the representations made are as follows. During his life, Grantor created nine trusts. Trust is one of the nine trusts and is the subject of this ruling request. Trust was created on Date 1, for the benefit of Grantor's spouse,

Spouse, Grantor's son, Child, and Grantor's issue. Currently, Child is the sole income beneficiary of Trust.

Article Third, subparagraph (a) of Trust provides that after Date 2, all of Trust's net income is to be paid to Child. Upon Child's death, the net income is to be paid to Child's issue, per stirpes, if any; if none, the net income is to be paid to Spouse, if she is living; if not, the net income is to be paid to Grantor's issue, per stirpes. Upon the termination of Trust, the trust estate is to be distributed to Child's issue, per stirpes, if living; if not, to Grantor's issue, per stirpes, if living; if not, to the issue (other than Grantor) of Grantor's parents, per stirpes, if living; if not, to the trustee of a named trust, if in existence; if not, to College.

Article Third, subparagraph (c) provides that after Date 2, the trustees have the discretion to distribute trust principal to the income beneficiary of Trust to provide for the beneficiary's support, maintenance, and education.

Article Third, subparagraph (f) provides that Trust will terminate at the earlier of the following events: (1) the death of the last survivor of certain named persons, and (2) the death of the last survivor of Spouse and all of Grantor's issue (including Child and his issue).

Article Seventh provides that Trust is to be governed under the laws of State 1.

Article Eighth provides that the governing law of Trust may be changed to another state.

In Year 1, the nine trusts entered into a partnership (Partnership) with three other trusts to coordinate investment activities. Under the partnership agreement, Partnership is required to distribute annually to the partner trusts an amount equal to the net accounting income determined by applying the broadest definition of net income under the laws of the states whose laws govern the administration of each of the trusts, respectively.

Currently, the laws of five different states govern the nine different trusts. Due to the administrative complexity and high costs involved in determining the proper distribution amount under the respective state laws of each separate trust, it was suggested that each of the partner trusts be amended to change governing local law to State 2. The trustees of Trust intend to change the governing law of Trust to State 2.

Effective as of January 1, 2002, State 2 amended its laws governing the administration of trusts by enacting legislation that adopts a new uniform principal and income act (Statute 1). It also enacted Statute 2, which permits a trustee of a trust that is subject to State's prudent investor rule to make adjustments between income and principal under specified circumstances (Statute 2).

Statute 2 provides, in part, that a trustee has a duty to invest and manage property held in a fiduciary capacity in accordance with the prudent investor standard defined therein. Statute 2 also provides that where Statute 1 applies to a trust and the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, the prudent investor standard also authorizes the trustee to adjust between principal and income to the extent the trustee considers it advisable to enable the trustee to make appropriate present and future distributions if the trustee determines, after applying the rules in Statute 1, that such an adjustment would be fair and reasonable to all of the beneficiaries, so that current beneficiaries may be given the use of the trust property as is consistent with preservation of its value.

The trustee has represented that Trust was irrevocable on September 25, 1985, and there were no additions to Trust after September 25, 1985.

Trustee is requesting the following three rulings.

1. The proposed amendment of Trust to change its governing law and the administration of Trust under the new governing law will not result in Trust or any beneficiary of Trust being treated as having made a taxable exchange for federal income tax purposes.
2. The proposed amendment of Trust to change its governing law and the administration of Trust under the new governing law will not be treated as a modification of Trust within the meaning of § 26.2601-1(b)(4) of the Generation-Skipping Transfer Tax Regulations that will cause Trust to lose its exemption from the application of chapter 13 of the Internal Revenue Code and that, after the proposed amendment, distributions from Trust and terminations with respect to Trust will continue to be exempt from chapter 13 pursuant to § 26.2601-1(b)(1)(i).
3. The proposed amendment of Trust to change its governing law and the administration of Trust under the new governing law will not result in any beneficiary of Trust being treated as having made a taxable gift for federal gift tax purposes.

Law and Analysis:

Ruling 1:

Section 61(a)(3) of the Code 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 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 § 1011 for determining loss over the amount realized.

Section 1001(b) states 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) 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.

The Supreme Court of the United States in Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991), concluded that § 1.1001-1 reasonably interprets § 1001(a) and stated that an exchange of property gives rise to a realization event under § 1001(a) if the properties exchanged are "materially different." 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. Cottage Savings, 499 U.S. at 564-65. 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. Cottage Savings, 499 U.S. at 566.

In the present case, it is consistent with the Supreme Court's opinion in Cottage Savings to find that the interests of the beneficiaries in Trust after the modification will not differ materially from their current interests. Under the proposed modification, Trust will be amended to change governing local law. However, Trust possesses the authority to make this change. See Article Eighth of Trust. Therefore, the proposed modification will not result in a material difference in kind or extent of the legal entitlements enjoyed by the beneficiaries. Accordingly, based upon the facts submitted and the representations made, a change in governing local law will not cause Trust or Trust beneficiaries to be treated as having a taxable exchange and no gain or loss is recognized for purposes of § 1001(a).

Rulings 2 and 3:

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 GST made after October 26, 1986. A GST is defined under § 2611(a) as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 2612(a) provides that the term taxable termination means a termination (by death, lapse of time, release of a power, or otherwise) of an interest in property held in trust where the property passes to a skip person with respect to the transferor of the property. Section 2612(b) provides that the term taxable distribution means any distribution from a trust to a skip person other than a taxable termination or a direct skip. Under § 2612(c)(1), a direct skip is a transfer subject to federal estate or gift tax made by a transferor to a skip person.

Under § 1433(a) of the Tax Reform Act of 1986 (Act) and § 26.2601-1(a), the GST is generally applicable to GSTs made after October 22, 1986. However, under § 1433(b)(2)(A) of the Act and § 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)(1)(ii), any trust in existence on September 25, 1985, will be considered irrevocable unless the settlor had a power that would have caused inclusion of the trust in his or her gross estate under § 2038 or 2042, if the settlor had died on September 25, 1985.

Section 26.2601-1(b)(4)(i) provides that, in general, this paragraph (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 paragraph (b)(1), (2), or (3) of this section (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 this paragraph are applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. Thus (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 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 paragraph (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 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 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 this chapter.

Section 26.2601-1(b)(4)(i)(E), Example 4 provides as follows. In 1980, Grantor, who was domiciled in State X, executed an irrevocable trust for the benefit of Grantor's issue, naming a State X bank as trustee. Under the terms of the trust, the trust is to terminate, in all events, no later than 21 years after the death of the last to die of certain designated individuals living at the time the trust was executed. The provisions of the trust do not specify that any particular state law is to govern the administration and construction of the trust. In State X, the common law rule against perpetuities applies to trusts. In 2002, a State Y bank is named as sole trustee. The effect of changing trustees is that the situs of the trust changes to State Y, and the laws of State Y govern the administration and construction of the trust. State Y law contains no rule against perpetuities. In this case, however, in view of the terms of the trust instrument, the trust will terminate at the same time before and after the change in situs. Accordingly, the change in situs does not shift any 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 transfer. Furthermore, the change in situs does not extend the time for vesting of any beneficial interest in the trust beyond that provided for in the original trust. Therefore, the trust will not be subject to the provisions of chapter 13. If, in this example, as a result of the change in situs, State Y law governed such that the time for vesting was extended beyond the period prescribed under the terms of the original trust instrument, the trust would not retain exempt status.

Section 26.2601-1(b)(4)(i)(E), Example 11 provides as follows. 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 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. 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.

Section 26.2601-1(b)(4)(i)(E), Example 12 provides as follows. The facts are the same as in Example 11, except that in 2002, State X amends its income and principal statute to permit the trustee to make adjustments between income and principal when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that shall or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding allocation of receipts between income and principal is unable to administer the trust impartially. The provision permitting the trustees to make these adjustments is effective in 2002 for trusts created at any time. The trustee invests and manages the trust assets under the state's prudent investor standard, and pursuant to authorization in the state statute, the trustee allocates receipts between the income and principal accounts in a manner to ensure the impartial administration of the trust. The administration of the trust in accordance with the state statute 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. 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 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 authorize the trustee to make adjustments between income and principal or if the situs was changed to such a state from State X.

In this case, Trust was irrevocable on September 25, 1985, and there were no additions to Trust after September 25, 1985. Pursuant to the terms of Article Eighth of Trust, Trust will be amended to change governing law from State 1 to State 2. The law

governing trusts in State 2 permits a trustee of a trust to make adjustments between income and principal to enable the trustee to make appropriate present and future distributions that are fair and reasonable to all of the beneficiaries of the trust. This situation is similar to the situation set forth in Example 12 in § 26.2601-1(b)(4)(i)(E), which concludes that a change similar to the one that the trustees propose to make to the Trust will not be considered to shift any beneficial interest in a trust and, therefore, will not be subject to the provisions of chapter 13.

In addition, under Article Third, subparagraph (f) of the trust agreement, Trust will terminate at the earlier of the following events: (1) the death of the last survivor of certain named persons, and (2) the death of the last survivor of Spouse and all of Grantor's issue (including Child and his issue). Because the termination date is specifically provided for in the trust instrument, the change in governing law from State 1 to State 2 will not change the termination date of Trust. This situation is similar to the situation set forth in § 26.2601-1(b)(4)(i)(E), Example 4. In this case, the date the trust will terminate before and after the change in governing law will be the same, and therefore, the change will not extend the time for vesting of any beneficial interest in the trust.

Finally, as noted above, the facts in this case are similar to those set forth in Example 12 in § 26.2601-1(b)(4)(i)(E). In addition to the conclusions relating to chapter 13, Example 12 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.

Accordingly, based upon the facts submitted and the representation made, we conclude that the change in the Trust's governing law from State 1 to State 2 and the administration of Trust under the new governing law will not be treated as a modification of Trust within the meaning of § 26.2601-1(b)(4) that will cause Trust to lose its exemption from the application of chapter 13 and that the change will not cause distributions from Trust and terminations with respect to Trust to not be exempt from chapter 13 pursuant to § 26.2601-1(b)(1)(i). We also conclude that the change in governing law and the administration of Trust under the new governing law will not result in any beneficiary of Trust being treated as having made a taxable gift for federal gift tax purposes.

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,

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

Enclosures: Copy for § 6110 purposes