

Internal Revenue Service

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Washington, DC 20224

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Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
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Date:
January 06, 2006

Trust =

A =

B =

State =

Court =

D1 =

D2 =

D3 =

Year =

1

x =

Dear :

This letter responds to a letter dated April 29, 2005, submitted on behalf of Trust by its authorized representative, requesting certain rulings under § 643 of the Internal Revenue Code.

The information submitted states that B died on D1, survived by B's spouse, A. B created a revocable trust, the terms of which provide that upon B's death, certain

assets shall be transferred to a Marital Trust (Trust) and a Survivor's Trust. The terms of Trust provide that all of the net income of Trust is distributable to or for the benefit of A in monthly or other convenient installments, but no less often than annually, during A's lifetime. The "special trustee" of Trust has a power, subject to certain limitations set forth in Trust, to direct distributions of principal to or for the benefit of A as deemed necessary for A's support, health, and comfort.

With respect to tax elections, Trust provides that the trustee shall have the power to take any action and to make any election to minimize the tax liabilities of Trust and Trust's beneficiaries, and except as otherwise expressly provided, shall allocate the benefits among the various beneficiaries, make adjustments in the rights of any beneficiaries, or between the income and principal accounts, to compensate for the consequences of any tax election or any investment or administrative decision that the trustee shall determine has had the effect of directly or indirectly preferring one beneficiary or group of beneficiaries over another.

With respect to principal and income, Trust provides that matters relating to the rights of beneficiaries among themselves as to principal and income shall be governed by the provisions of the Revised Principal and Income Act from time to time existing. In the event the Revised Principal and Income Act shall contain no provision concerning a particular item, the trustee shall have the power to determine what is principal or income and apportion and allocate, in its reasonable discretion, receipts and expenses as between these accounts.

Trust provides that State law shall govern the validity and construction of Trust and all rights thereunder, except as to rights, title, and interest in real property held in Trust. State's Principal and Income Act does not define "income" by reference to a unitrust or similar amount. The Act does allow a trustee to make adjustments between principal and income under certain conditions.

Court issued an order effective D2, in conjunction with an agreement among A, the trustee of Trust, and the special trustee of Trust, which in relevant part directs the trustee and special trustee (collectively, the Trustees) to pay A an amount equal to a x% annual return on all of the combined equity investments of Trust and the Survivor's Trust or the actual net income derived from those equity investments, whichever is greater, together with the net income derived from all other assets of Trust and the Survivor's Trust. As used in the order, the term "equity investments" means publicly traded stocks and other equity securities.

In all taxable years since the effective date of the Court order, the x% annual return amount (the Percentage Amount) of the equity investments of Trust and the Survivor's Trust has exceeded the actual net income derived from the equity investments. Therefore, in each year, the Trustees have been required to distribute an amount equal to the actual net income of the equity investments and other assets of Trust and the Survivor's Trust, and an amount (the Additional Amount) necessary to

comply with the Court order. In order to pay the Additional Amount, the Trustees have sold some of Trust's equity investments, realizing net capital gains.

The Trustees have not included any portion of the net capital gains realized on the sale of the equity investments in Trust's distributable net income (DNI) for any taxable year. All net capital gains have been reported on Trust's federal income tax returns. In each taxable year, the Trustees reduced the Additional Amount actually paid to A by a sum estimated by the Trustees as equal to the amount of additional income tax payable by Trust because of the sale of the equity investments necessary to obtain the cash to pay the Additional Amount. In its books and records, Trust allocated to principal all net capital gains attributable to the sales of the equity investments.

On D3, A filed a petition with Court seeking to compel the Trustees to distribute the Additional Amount without reduction for capital gains taxes paid or payable by Trust and to recover all amounts previously withheld from the Additional Amounts payable to A to account for capital gains taxes paid by Trust.

A and the Trustees have reached a settlement of the issues raised in A's petition. Under the settlement, beginning in Year 1, the Trustees would (a) cease from withholding from the Additional Amount distributions to A any sums to account for capital gains taxes paid by Trust; (b) make a one-time lump-sum distribution to A of a portion of those amounts previously withheld from distribution to reflect capital gains taxes paid by Trust; and (c) exclude all net capital gains from DNI of Trust on Trust's federal income tax returns in the year of the lump-sum distribution and all later taxable years of Trust.

Section 643(a)(3) provides that for purposes of part I of subchapter J, gains from the sale or exchange of capital assets shall be excluded from DNI to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in § 642(c). Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The exclusion under § 1202 shall not be taken into account.

Section 1.643(a)-3(a) of the Income Tax Regulations provides that in general, except as provided in § 1.643(a)-6 and § 1.643(a)-3(b), gains from the sale or exchange of capital assets are ordinarily excluded from DNI and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

Section 1.643(a)-3(b) provides that gains from the sale or exchange of capital assets are included in DNI to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by

applicable local law or by the governing instrument if not prohibited by applicable local law): (1) allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of DNI determined without regard to § 1.643(a)-3(b); (2) allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or (3) allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

Based solely on the facts and representations submitted, we conclude that the exclusion of all of Trust's capital gains from DNI in the year for which the lump-sum distribution is made will be considered a reasonable allocation under § 643(a)(3) and § 1.643(a)-3(b)(2). In future taxable years of Trust, the exclusion of capital gains from DNI will also be considered a reasonable allocation under § 643(a)(3) and § 1.643(a)-3(b)(2). Trustees must consistently follow the practice of excluding all of Trust's capital gains from DNI.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provisions of the Code.

This ruling is directed only to the taxpayer that requested it. Section 6110(j)(3) provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file, a copy of this letter is being sent to Trust's authorized representative.

Sincerely,

J. THOMAS HINES
Chief, Branch 2
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures: 2
Copy of this letter
Copy for § 6110