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PLR-102773-06

Date:

May 11, 2006

Legend

Trust =

Grantor =

Child =

Year 1 =

State 1 =

State 2 =

Dear

This letter responds to your letter, dated February 24, 2006, and prior correspondence requesting rulings regarding the income and generation-skipping transfer (GST) tax consequences of the proposed modifications of Trust.

Grantor created Trust under Article III of his Last Will and Testament for the benefit of Grantor's wife, Child and Child's issue. Grantor's wife predeceased Grantor. Grantor died in Year 1. After the death of Grantor's wife, Article IV of the Grantor's will provides for mandatory distributions of net income to Child during Child's life. Upon Child's death, the trustee shall divide the principal in equal shares, per stirpes, for Child's issue.

In Year 1, all interested parties lived in State 1. Year 1 is prior to September 25, 1985. The trustees represent that Trust was irrevocable prior to September 25, 1985, and no additions were made to Trust after September 25, 1985. Child now lives in State 2.

While the value of the Trust assets have increased, the value of the net income has decreased and is no longer sufficient to maintain him at the standard of living to which he has become accustomed. State 2 has adopted a statute that allows net

income distributions under trusts administered in State 2 to be replaced with distributions based on a percentage of the fair market value of the trust assets.

The trustees of Trust propose to modify Trust to change the situs of the Trust from State 1 to State 2. After the Trust situs has been changed, the trustees will adopt a 5 percent unitrust distribution standard under the applicable State 2 statute. The trustees have requested rulings that proposed modifications will not cause Trust to lose its exempt status for GST tax purposes and will not result in Trust or any beneficiary of Trust being treated as having made a taxable exchange for federal income tax purposes.

### Generation-Skipping Transfer Tax Ruling

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

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 4 illustrates the tax effect of changing the situs of a trust. In that case, Grantor, who was domiciled in State X, executed an irrevocable trust in 1980 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 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(s) 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 of the Internal Revenue Code. If 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 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, Trust will terminate at the same time before and after the change in situs under the terms of the Trust agreement. Accordingly, changing the situs of Trust from State 1 to State 2 will not extend the time for vesting. See §26.2601-1(b)(4)(i)(E), Example 4. Therefore, changing the trust situs will not cause Trust to lose its status as exempt from the GST tax.

With respect to the proposed conversion from a mandatory distribution of net income to a 5 percent unitrust interest under State 2 law, the proposed modification 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 conversion to a unitrust interest under State 2 law will not cause Trust to lose its status as exempt from the GST tax.

### Income Tax Ruling

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 the State 2 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 2 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.

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. We are specifically not ruling on the potential income or GST tax effect of a hypothetical future conversion from a unitrust interest back to a mandatory distribution of net income in accordance with section 6.12 of Rev. Proc. 2006-1.

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,

Melissa C. Liquerman

Melissa C. Liquerman  
Branch Chief, Branch 9  
(Passthroughs & Special Industries)

Enclosure

Copy for § 6110 Purposes

cc: