Internal Revenue Service

Number: **200702013**
Release Date: 1/12/2007
Index Number: 1001.00-00, 2056.00-00,
2501.01-00, 2601.01-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

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Refer Reply To:
CC:PSI:4
PLR-112815-06
Date: OCTOBER 10, 2006

RE:

Legend:

Date 1	=
Date 2	=
Date 3	=
Trust	=
Trust F	=
Trust M	=
Settlor	=
Spouse	=
J	=
K	=
L	=
$T	=
State	=
State Statute	=

Dear :

This is in response to your authorized representative's submission dated January 31, 2006, in which a ruling was requested on the income, gift, estate, and generation-skipping transfer (GST) tax consequences of a proposed action with respect to Trust M and Trust F, as described below.

According to the facts submitted, Settlor established Trust, a revocable living trust, on Date 1. Settlor amended Trust on Date 2. Settlor died on Date 3, after September 25, 1985, survived by Settlor's spouse, Spouse, three sons, (J, K, and L), and seven grandchildren.

Under the terms of Article First, Paragraph 1.01 of Trust, during Settlor's lifetime, the trustee is to pay the net income from the trust estate in convenient installments to Settlor or otherwise as Settlor may direct at any time. Upon Settlor's death, Trust became irrevocable and was divided into two trusts: a family trust (Trust F), and a marital trust (Trust M) intended to qualify as qualified terminable interest property under section 2056(b)(7).

Regarding Trust F, Article Fourth, Paragraph 4.01, provides generally that if Spouse survives Settlor, Trustee is to fund Trust F with the largest pecuniary amount which will not result in or increase federal estate tax payable by reason of Settlor's death. Paragraph 4.02(A) provides that commencing with the death of Settlor, Trustee is to distribute the income of Trust F in convenient installments, at least quarterly, to Spouse, for the remainder of his lifetime. Paragraph 4.02(B) provides that Trustee is authorized to disburse from the principal of Trust F such sum or sums as the Trustee deems necessary, in its sole discretion, to provide for the health, education, maintenance and support of Spouse, taking into account the standard in which he shall have been accustomed to live, and taking into account such other assets, property or income as may be available to him for such purposes.

Under Paragraph 4.02(D), upon the death of Spouse, the principal of Trust F is to be held or distributed to or in trust for such one or more of Settlor's descendants and their respective spouses (subject to a limitation in paragraph (D)(1)) and/or charitable, scientific or education purposes, with such powers and in such manner and proportions as Spouse may appoint by will, making specific reference to the special power of appointment. To the extent that Spouse fails to exercise the special power of appointment, then upon Spouse's death, the Trust F assets are to be distributed in accordance with Paragraphs 4.02(D)1-3. Spouse may not appoint any part of Trust F to himself or his creditors.

Regarding Trust M, Article Fifth, Paragraph 5.01 provides that if Spouse survives Settlor, Trust M is to be funded with a pecuniary amount equal to the Settlor's federal generation-skipping transfer (GST) tax exemption which remained unallocated immediately before the death of Settlor, less the value for GST tax purposes of (i) the amount passing to Trust F and (ii) all direct skips occurring by reason of the death of the Settlor (other than direct skips caused by a disclaimer or from a trust not created or appointed by the Settlor.)

Under Paragraph 5.01(D), the Trustee is to pay all of the net income of Trust M, at least annually to Spouse during the remainder of his lifetime. Any accrued income of Trust M which shall be undistributed at the death of Spouse shall be payable to his estate. Paragraph 5.01(E) provides that the Trustee shall be authorized, in Trustee's sole and absolute discretion, to invade the principal of Trust M to provide for the health, support, and maintenance of Spouse. Under Paragraph 5.01(G)(4), upon the death of

Spouse, the remainder of the principal of Trust M is to be added to or used to fund Trust F and is to be distributed in accordance Paragraph 4.02(D).

Finally, under Paragraph 5.02, the balance of the Trust estate (i.e., the balance remaining after funding Trust F and Trust M) is to be distributed outright to Spouse.

It is represented that Settlor's personal representative made a timely QTIP election under section 2056(b)(7) with respect to Trust M on the federal estate tax return (Form 706) filed by Settlor's estate. It is represented that on Schedule R, Settlor's personal representative allocated Settlor's GST exemption between Trust M and Trust F, such that both trusts have an inclusion ratio for generation-skipping transfer (GST) tax purposes, under section 2642(a), of zero.

Spouse is currently serving as Trustee of Trust M and Trust F.

State Statute provides that, under certain conditions, a "trustee may, without court approval, convert an income trust to a total return unitrust, reconvert a total return unitrust to an income trust, or change the percentage used to calculate the unitrust amount or the method used to determine the fair market value of the trust." Generally, an "Income Trust" is defined as a trust, created by either an inter vivos or a testamentary instrument, which directs or permits the trustee to distribute the net income of the trust to one or more persons, either in fixed proportions or in amounts or proportions determined by the trustee and regardless of whether the trust directs or permits the trustee to distribute the principal of the trust to one or more such persons. The term "Unitrust Amount" is defined as the amount determined by multiplying the fair market value of the assets determined at least annually by the percentage calculated under the statute. Under the statute, the percentage used to calculate the unitrust amount can not be greater than 5 percent or less than 3 percent.

Pursuant to State Statute, the trustee proposes to convert Trust F and Trust M to total return unitrusts. It is represented that the Trustee will select a percentage to be used to calculate the unitrust amount that will be, in accordance with State Statute, not greater than 5 percent or less than 3 percent. Further, it is represented that the trustee will comply with all requirements of State Statute.

Rulings have been requested that the proposed conversion of Trust M and Trust F from income trusts to total return unitrusts, pursuant to the laws of State: (1) will not affect the GST tax zero inclusion ratios of Trust M and Trust F; (2) will not result in a taxable gift for federal gift tax purposes by the beneficiaries of Trust F and Trust M; (3) will not result in the loss of the estate tax marital deduction with respect to Trust M; (4) will not constitute a recognition event for purposes of section 1001 of the Internal Revenue Code.

Ruling 1.

Section 2601 of the Internal Revenue Code imposes a tax on every generation-skipping transfer. Under section 1433(a) of the Tax Reform Act of 1986 (Act) and section 26.2601-1(a) of the Generation-Skipping Transfer Tax Regulations, the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under section 1433(b)(2)(A) of the Act and section 26.2601-1(b)(1)(i), the tax 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).

Section 26.2601-1(b)(4)(i) 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 because it was irrevocable prior to September 25, 1985, will not cause the trust to lose its exempt status. The regulation provides that the rules contained in the paragraph are generally applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. Unless noted otherwise, 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 section 1001.

Section 26.2601-1(b)(4)(i)(D) provides that a modification 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 section 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. 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. 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 section 1.643(b)-1 of the Income Tax Regulations.

Section 1.643(b)-1 provides that for purposes of determining the meaning of the term income as used in various Internal Revenue Code sections relating to the income taxation of trusts, 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. Under the regulation, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% 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 26.2601-1(b)(4)(i)(E), Example 11, considers a situation where a trust that is otherwise exempt from the GST tax because it was irrevocable prior to September 25, 1985, 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. State X, the situs of the trust, amends its income and principal statute to define income as a unitrust amount of 4% of the fair market value of the trust assets valued annually. The example concludes that the administration of the trust in accordance with the state statute defining the income to be a 4% unitrust amount will not be considered to shift a beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13. Further, the example states that, 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.

In the instant case, Trust F and Trust M became irrevocable after September 25, 1985, and it is represented that sufficient GST exemption has been allocated to the trusts such that each trust has an inclusion ratio of zero under section 2642. No guidance has been issued concerning modifications that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption was allocated to the trusts to result in an inclusion ratio of zero. At a minimum, a modification that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of such a trust.

The trustee proposes to administer Trust F and Trust M pursuant to State Statute which meets the requirements of section 1.643(b)-1 and section 26.2601-1(b)(4)(i)(D). Therefore, the conversion and administration of Trust F and Trust M pursuant to State Statute, as described above, does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 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. See section 26.2601-1(b)(4)(i)(E), Example 11. Accordingly, we conclude that the conversion and administration of Trust F and Trust M pursuant to State Statute will not affect the GST zero inclusion ratios of Trust F and Trust M.

Ruling 2.

Section 2501(a) imposes a tax for each calendar year on the transfer of property by gift during the calendar year by any individual, resident or nonresident.

Section 2511(a) provides that the tax imposed by section 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 the gift is made in property, the value thereof at the date of the gift is considered the amount of the gift. Section 2512(b) provides that where property is transferred for less than adequate and full consideration in money's worth, then the amount by which the value of the property exceeds the value of the consideration is deemed to be a gift, and is included in computing the amount of gifts made during the taxable year.

As discussed above, we have concluded that State Statute meets the requirements of section 1.643(b)-1 and section 26.2601-1(b)(4)(i)(D). Further, as discussed above, section 26.2601-1(b)(i)(4)(E), Example 11, concludes that the administration of the trust discussed in the example pursuant to a state statute that meets the requirements of section 1.643(b)-1 and section 26.2601-1(b)(4)(i)(D) will not result in any trust beneficiary being treated as having made a gift for federal gift tax purposes. Accordingly, we conclude that the conversion and administration of Trust F and Trust M pursuant to State Statue as proposed, will not cause the beneficiaries of Trust F and Trust M to be treated as making taxable gifts for federal gift tax purposes under section 2501.

Ruling 3.

Section 2056(a) provides that, for purposes of the tax imposed by section 2001, the value of the taxable estate is to be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property that passes or has passed from the decedent to the surviving spouse.

Section 2056(b)(1) provides that where on the lapse of time, on the occurrence of an event or contingency, or the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, no deduction is allowed with respect to such interest - (A) if an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse); and (B) if by reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse.

Under section 2056(b)(7)(A)(i), for purposes of section 2056(a), qualified terminable interest property shall be treated as passing to the surviving spouse, and (ii) for purposes of section 2056(b)(1)(A), no part of such property shall be treated as passing to any person other than the surviving spouse.

Section 2056(b)(7)(B)(i) provides that the term "qualified terminable interest property" means property – (I) which passes from the decedent, (II) in which the surviving spouse has a qualifying income interest for life, and (III) to which an election applies under section 2056(b)(7).

Section 2056(b)(7)(B)(ii) provides that the surviving spouse has a qualifying income interest for life if - (I) the surviving spouse is entitled to all of the income from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property, and (II) no person has a power to appoint any part of the property to any person other than the surviving spouse.

Section 20.2056(b)-7(d)(2) of the Estate Tax Regulations provides that the principles of section 20.2056(b)-5(f), relating to whether the spouse is entitled for life to all the income from the entire interest or a specific portion of the entire interest for purposes of section 2056(b)(5), apply in determining whether the surviving spouse is entitled for life to all of the income from the property for purposes of section 2056(b)(7). Section 20.2056(b)-5(f)(1) provides that the surviving spouse's interest shall meet the condition that the spouse is entitled for life to all the income from the property if the spouse is entitled to income as determined by applicable local law that provides for a reasonable apportionment between income and remainder beneficiaries of the total return of the trust and that meets the requirements of section 1.643(b)-1.

As discussed above, we have concluded that State Statute meets the requirements of section 1.643(b)-1. Accordingly, the conversion and administration of Trust M pursuant to State Statute, as proposed, will not result in the loss of the estate tax marital deduction with respect to Trust M.

Ruling 4.

Section 61(a)(3) of the Internal Revenue 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 is the excess of the amount realized over the adjusted basis provided in section 1011 for determining gain, and the loss is the excess of the adjusted basis provided in section 1011 for determining loss over the amount realized. Under section 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 in kind of extent, is treated as income or as loss sustained.

Rev. Rul. 56-437, 1956-2 C.B. 507, provides that a partition of jointly owned property is not a sale or other disposition of property where the co-owners of the joint property sever their joint interests, but do not acquire a new or additional interest as a result of the transaction. Thus, neither gain nor loss is realized on a partition.

Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991), provides that an exchange of property results in the realization of gain or loss under section 1001 if the properties exchanged are materially different. 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 by 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 section 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.

State Statute provides that, under certain conditions, a "trustee may, without court approval, convert an income trust to a total return unitrust, reconvert a total return unitrust to an income trust, or change the percentage used to calculate the unitrust amount or the method used to determine the fair market value of the trust."

State Statute specifically authorizes the conversion of an income trust to a total return trust, and vice versa. In the instant case, the conversion of the trusts in the manner described is authorized under State law. The Trustee has authority, pursuant to State Statute, to convert the trusts to total return trusts, as that term is defined under State law. The mere exercise of trustee authority is not a sale or other disposition under section 1001 of a trust interest by any beneficiary. Thus, neither gain nor loss is recognized on the conversion.

Accordingly, based on the facts submitted and representations made, we conclude that conversion of Trust M and Trust F from income trusts to total return trusts will not constitute a recognition event for purposes of section 1001 of the Code.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

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.

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.

Sincerely yours,

_____

George Masnik
Branch Chief, Branch 4
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure:
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