Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Person To Contact:
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Telephone Number:

Refer Reply To:
CC:PSI:B04
PLR-149876-07
Date:
May 23, 2008

Re:

Legend
Settlor =
Trust =

State =
Daughter =
Current Beneficiaries =

Date 1 =
Date 2 =
Date 3 =

Date 4 =
Date 5 =

State Statute 1 =
State Statute 2 =
Court =

Dear

This letter responds to your letter dated October 25, 2007, and subsequent correspondence, requesting income, gift and generation-skipping transfer (GST) tax rulings with respect to the proposed conversion of Trust to a total return trust under State law. In a telephone conference with a member of this office, you were advised that the Internal Revenue Service declines to rule with respect to the gift and GST issues. See § 6.11 of Rev. Proc. 2008-1, 2008-1 I.R.B. 1, 15, and § 3.01(65) Rev. Proc. 2008-3, 2008-1 I.R.B. 110, 114.

FACTS

Settlor created an irrevocable trust on Date 1. On Date 2, a State court divided the trust into four separate trusts, one for each child and line of descent of the Settlor. The separate trust for the benefit of Settlor's daughter, Daughter, and her descendants is Trust. Trust is governed by the laws of State. No property has been added to Trust at any time after September 25, 1985.

Pursuant to the terms of Trust, Trust will continue until 20 years after the death of seven individuals, the last of whom, Daughter, died on Date 3. Accordingly, Trust will terminate on Date 4, the termination date. By her last will, Daughter exercised her power under Trust to change the proportions in which her descendants share in the income of Trust and, as a result, upon termination of Trust, the principal. Trust income currently is paid to Daughter's children and grandchildren, the Current Beneficiaries, in varying percentages. On termination, Trust's assets will be distributed to the beneficiaries receiving income at that time in the same proportions as they are then receiving income. If there is no living descendant of Daughter, Trust property is to be distributed per stirpes among the then living descendants of the Settlor's four children, or if there is no such then living descendant, per capita among the then living descendants of the Settlor's brothers.

State Statute 1 permits a court to convert a trust to a total return trust or unitrust if the court determines that the conversion will enable the trustee to better carry out the purposes of the trust and that the conversion is in the best interest of the beneficiaries. State Statute 1 provides that following conversion of a trust to a total return trust, "income" in the governing instrument means an annual amount equal to a percentage of the net fair market value of the total trust assets averaged over a three-year period, as opposed to "income" as defined under State Statute 2. State Statute 1 further provides that the court has the power to determine the distribution percentage, i.e., the percentage of the total value of the trust assets to be distributed from a total return trust.

On Date 5, the co-trustees petitioned Court requesting that Court: (i) convert Trust to a total return trust under State Statute 1, and (ii) approve a 3% distribution percentage from Trust after conversion. The co-trustees have also asked Court to declare that on Trust's termination, Trust assets will be distributed to the persons then in receipt of a portion of the unitrust amount (instead of the income as formerly determined) in the same proportions as the unitrust amount then being paid.

You have requested a ruling that the conversion of Trust to a total return trust under State Statutes 1 and 2 will not cause Trust or any beneficiary of Trust to realize any taxable income (capital gain or otherwise) from an exchange of a Trust interest for income tax purposes.

LAW AND ANALYSIS

Section 61(a)(3) and (15) of the Internal Revenue Code provides that gross income means all income from whatever source derived, including gains derived from dealings in property and income from an interest in an estate or trust.

Under § 1001(a), 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 such section for determining loss over the amount realized. Under § 1.1001-1(a) of the Income Tax Regulations, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially in kind or in extent, is treated as income or loss sustained.

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. 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(c)(1) provides that a loss is not ordinarily sustained prior to the sale or other disposition of the property for the reason that until such sale or other disposition occurs there remains the possibility that the taxpayer may recover or recoup some of the adjusted basis of the property. Until some identifiable event fixes the actual sustaining of a loss and the amount thereof, the loss is not taken into account.

An exchange of property results in the realization of gain or loss under § 1001 if the properties 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 Supreme Court held that mortgage loans made to different obligors and secured by different homes embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans. Id. 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.

Section 1.643(b)-1 provides a comprehensive definition of "income" as that term applies to trusts and estates. It provides, in part, that 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% 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 1.643(b)-1 further provides that a switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of § 1001.

In the present case, the preliminary question is whether the beneficiaries of Trust will have the same property interests and legal entitlements as a result of the proposed conversion. The regulations under § 643 conclude, by inference, that a conversion of an income trust to a total return trust or unitrust does not result in material changes in property interests or legal entitlements that are different in kind or extent.

Under the State Statute 1, a conversion to a total return trust may be made upon the court's determination that the conversion will enable the trustee to better carry out the purposes of the trust. In addition, and under the facts presented, there is to be no material change in property interests or legal entitlements for Trust or Trust's beneficiaries. If the conversion to a total return trust pursuant to a state statute does not result in a material change in property interest or legal entitlements, there is no occasion for realizing taxable gain or loss under § 1001. Therefore, under the facts presented, we conclude that the conversion will not trigger realization of gain or loss under § 1001 for Trust or Trust's beneficiaries for federal income tax purposes.

Except as specifically ruled above, no opinion is expressed as to the federal tax consequences of the facts described above under the cited provisions or any other provisions of the Code or regulations.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statements executed by the appropriate parties. While this office has not verified any part of the material submitted in support of the request for rulings, it is subject to verification and examination.

This ruling is directed only to the taxpayers requesting it. Section 6110(k)(3) of the Code 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 ruling is being sent to your authorized representative.

Sincerely yours,

Lorraine E. Gardner
Senior Counsel, Branch 4
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure
Copy for section 6110 purposes