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Re:

Legend

Grantor =
Spouse =
Trust =

Trust 1 =

Trust 2 =

Agreement =

Son =
Son's Spouse =
Daughter =
Spouse =
Bank =
Date 1 =
Date 2 =
Date 3 =
Year =
State =
State Statute 1 =
State Statute 2 =
State Statute 3 =
State Statute 4 =

Dear

This letter responds to your authorized representative's letter of September 20, 2010, requesting rulings on the income, estate, gift, and generation-skipping transfer (GST) tax consequences of the proposed reformation of Trust 1.

The facts submitted are as follows. Grantor and Spouse each created an inter vivos revocable trust (Trust) on Date 1. Grantor contributed her separate assets to Trust. Grantor died on Date 2, a date before September 26, 1985. After the death of Grantor, Trust was to be continued for Spouse, Son and Daughter. Following the death of Spouse, Trust was divided into two trusts, Trust 1 for the benefit of Son, and Trust 2 for the benefit of Daughter. Trust is governed by the laws of State. Son and Bank are co-trustees (Trustees). Trust 1 is the subject of this ruling request.

Article VII of Trust, provides that during Son's life, all income from Trust 1 is to be distributed to Son. After the death of Son, if Son's Spouse survives him, Trustees will distribute one-half of the income to Son's Spouse during her lifetime, and the remaining one-half to Grantor's then living grandchildren, share and share alike. Principal may be distributed to Son in case of illness or economic emergency up to the greater of $5,000 or five percent of the trust assets for his support, maintenance and health consistent with his standard of living. If in the opinion of Trustees, the income is not sufficient, principal may be distributed to Son's children prior to reaching the age of 22 or when they complete their education for their support, maintenance and education. Upon the death of Son and Son's Spouse, if the Son's youngest living child has reached the age of 35, all of the remaining trust estate is to be distributed to Grantor's grandchildren, share and share alike, and to the issue of a deceased grandchild *per stirpes.*

Article III(b) of Trust grants Son sole investment authority over Trust 1 assets provided that Son is serving as on of the trustees of Trust. It further provides, generally, that Bank will rely on Son's investment advice and follow Son's instructions. Bank is not liable for any losses that occur from following Son's instructions. In the event of Son's resignation, death or inability to serve as one of the trustees, Bank will serve as sole trustee.

Article III(c) of Trust defines the term "income" as all of the income of the trust estate, less costs of administration and all proper charges against the estate. Whether or not incoming funds or rights or ownerships constitute income shall be determined under the general powers of the Trustees.

Paragraph (c) of the "General Powers of the Trustee," attached as an addendum to Trust, provides that the trustee need not make any adjustments in bookkeeping as between income and principal accounts in connection with premiums paid or discounts received on securities purchased. It is authorized to credit or to charge premiums or discounts to investments, to credit scrip, stock dividends, extraordinary dividends, or other receipts, and to charge estate or inheritance or other taxes or charges, either to or against principal or income, as in its discretion shall seem proper under the circumstances.

State enacted State Statute 1 which provides, in relevant part, that a trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages the trust assets as a prudent investor, and the terms of the trust describe the amount to be distributed to a beneficiary by referring to the trust's income. In deciding whether and to what extent to exercise this power, a trustee shall consider all factors relevant to the trust and its beneficiaries, including certain listed factors.

State Statute 1 further provides, in relevant part, that a trustee may not make an adjustment: (i) if possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust for income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to make an adjustment; (ii) if possessing or exercising the power to make an adjustment causes all or part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, and the assets would not be included in the estate of the individual if the trustee did not possess the power to make an adjustment; (iii) if the trustee is a beneficiary of the trust; or (iv) if the trustee is not a beneficiary, but the adjustment would benefit him directly or indirectly.

State Statute 2 provides that, in exercising the power to adjust under Statute 1, a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable to all the beneficiaries, except to the extent that the terms of the trust clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries.

State Statute 3 provides, generally, that its purpose is to provide statutory provisions for the resolution of disputes and other matters involving trusts and estates. State Statute 3 further provides that the provisions are intended to provide nonjudicial methods for the resolution of matters, including agreement.

State Statute 4 provides, in relevant part, that if all parties agree to a resolution of any dispute under State Statute 3, then the agreement must be a written agreement signed by all parties. The written agreement is binding and conclusive on all persons interested in the trust.

On Date 3, Trustees and the beneficiaries of Trust 1 (including the current beneficiary and contingent beneficiaries by representation) entered into a nonjudicial dispute resolution agreement (Agreement) pursuant to State Statute 3. Agreement is intended to comply with the requirements of State Statute 4 and becomes effective on the date Trustees obtain a favorable private letter ruling from the Internal Revenue Service.

Pursuant to the terms of Agreement, the Trustees and the beneficiaries have agreed to amend and modify Trust 1 as follows:

(A) To provide that Son as Trustee has sole management and investment authority over Trust 1's assets;

(B) To remove the requirement that Bank review and approve Son's investment decisions, including Bank's right to approve or disapprove a change in Trust 1's assets;

(C) To address the adjustment of receipts between principal and income;

(D) To provide that Son invests Trust 1's assets prudently;

(E) To provide that in the event of resignation, death or inability of Son to serve as Trustee, Bank will serve as sole trustee and have sole investment authority over Trust 1's assets. If Bank determines, due to incapacity, that Son is no longer capable of investing and managing Trust 1's assets, Bank may request Son resign as Trustee, may disregard his investment instructions, and/or may take steps to remove Son as Trustee;

(F) To provide that granting sole investment authority to Son involves risks;

(G) To provide that Bank may exercise its discretion to adjust receipts between income and principal;

(H) To acknowledge the manner in which Bank has previously adjusted receipts between income and principal and to determine the tax treatment of receipts for prior tax years;

(I) To determine treatment of future distributions;

(J) To provide that the adjustment between principal and income fulfills Bank's duty or impartiality between current and contingent beneficiaries and that if the Internal Revenue Service does assess any federal income, gift, estate or generation-skipping transfer tax, the tax will be assessed against the trust for such beneficiary; and

(K) To establish that the trustees will not be liable to the beneficiaries for their actions with respect to Trust 1's investments and that Bank will not be liable with respect to the adjustment of receipts between principal and income and the distribution of such receipts to Son.

In Recital U of Agreement, the parties define the term “Receipts” to mean interest, dividends, return of principal, capital gain dividends, and capital gain distributions. The term “Receipts” does not include: (1) money received in partial liquidation to the extent that the entity, at or near the time of distribution, indicates that it is a distribution in partial liquidation; (2) money or property received if the total amount of money and property distributed in a distribution or series of related distributions is greater than twenty percent (20 percent) of the entity’s gross assets as shown by the entity’s year-end financial statements immediately preceding the initial distribution; or (3) capital gain realized through the sale of investments in the ordinary course of business.

Section 6 of Agreement provides that the parties acknowledge and agree that for taxable years prior to Date 2, Bank has been adjusting receipts between principal and income, treating all receipts as income, and paying such receipts out of income to Son in a manner that was fair and reasonable.

Section 7 of Agreement provides that the parties acknowledge and agree that for Year and for all taxable years following, Bank will have the power to adjust receipts between principal and income, treat all receipts as income, and distribute such income to Son during his lifetime and to one or more of the beneficiaries following his death pursuant to the powers granted to Bank in the State Principal and Income Act.

Trustees have requested the following rulings:

1. That the reformation of Trust 1 and Bank’s power to adjust between principal and income will not constitute a sale, exchange, or other disposition of Trust 1’s assets and will not result in the recognition of any gain or loss by Trust 1 or the beneficiaries for federal income tax purposes;

2. That Bank’s adjustment between principal and income and any resulting distributions of capital gain to Son will be treated as income for federal income tax purposes;

3. That Bank’s possession and exercise of the power to adjust between principal and income will not cause any of the beneficiaries of Trust 1 or Bank to be treated as the owner of any part of Trust 1’s assets under § 678 of the Internal Revenue Code;

4. That the reformation of Trust 1 and Bank’s power to adjust between principal and income will not cause Trust 1 to lose its status under § 1433 of the Tax Reform Act of 1986 as exempt from the GST tax under chapter 13;

5. That Bank's possession and exercise of the power to adjust between principal and income will not constitute a taxable transfer by any beneficiary to Trust 1 for federal gift tax purposes; and

6. That the reformation of Trust 1 and Bank's power to adjust between principal and income will not cause any part of Trust 1's assets to be included in a beneficiary's estate under § 2041.

Rulings 1 through 3

Section 1.643(b)-1 of the Income Tax Regulations 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 percent and no more than 5 percent 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. Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally 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. A switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding nonjudicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of § 1001.

In this case, Trustees and the beneficiaries executed Agreement pursuant to State Statute 3 and State Statute 1 which permits Bank to make adjustments between income and principal to fulfill Bank's duty of impartiality between the income and remainder beneficiaries. The execution of Agreement constitutes a switch between methods of determining trust income authorized by State Statute. Bank's ability to allocate amounts between income and principal, including ordinary and tax-exempt income, capital gains, and appreciation, pursuant to State Statute 1 will be respected because it is a reasonable apportionment between the income and remainder beneficiaries.

Section 671 provides that where it is specified in subpart E of part I of subchapter J that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Section 678(a) provides, in general, that a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principals of §§ 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

In this case, Trustees and the beneficiaries executed Agreement pursuant to State Statute 3 and State Statute 1 which permits Bank to make adjustments between income and principal to fulfill Bank's duty of impartiality between the income and remainder beneficiaries. The ability of Bank to make adjustments between income and principal to fulfill the Bank's duty of impartiality does not cause Bank to have a power exercisable solely by itself to vest the corpus or the income therefrom in itself under § 678(a)(1). With respect to the beneficiaries, the execution of Agreement constitutes a switch between methods of determining trust income authorized by State Statute1 and does not cause any of the beneficiaries to hold a power exercisable solely by any beneficiary to vest the corpus or the income therefrom in himself under § 678(a)(1). The switch between methods of determining trust income authorized by State Statute1 will not constitute a release or modification of a power described in § 678(a)(2) by either Bank or the beneficiaries.

Based on the facts submitted and representations made, we conclude the following:

1. The reformation of Trust 1 and Bank’s power to adjust between principal and income will not, pursuant to § 1.643(b)-1, constitute a sale, exchange, or other disposition of Trust 1’s assets and will not result in the recognition of any gain or loss by Trust 1 or the beneficiaries for federal income tax purposes,

2. Bank’s adjustment between principal and income and any resulting distributions of capital gain to Son will be treated as income under § 1.643(b)-1.

3. Bank’s possession and exercise of the power to adjust between principal and income will not cause any of the beneficiaries of Trust 1 or Bank to be treated as the owner of any part of the Trust 1’s assets under § 678.

<u>Ruling 4</u>

Section 2601 imposes a tax on every generation-skipping transfer made after October 26, 1986.

Under § 1433(a) of the Tax Reform Act of 1986 (Act) and § 26.2601-1(a) of the Generation-Skipping Transfer Tax Regulations, the GST tax 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 tax does not apply to a transfer under a trust 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). Under § 26.2601-1(b)(1)(ii), any trust in existence on September 25, 1985, will be considered irrevocable unless the decedent had a power that would have caused inclusion of the trust in his or her gross estate under § 2038 or § 2042, if the decedent had died on September 25, 1985.

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 GST tax under § 26.2601-1(b)(1), (2), or (3) will not cause the trust to lose its exempt status. Under the regulation, unless specifically provided otherwise, these rules 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 § 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 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.

Section 26.2601-1(b)(4)(i)(E), *Example 12*, considers a situation where, in 1980, the Grantor, a resident of State X, establishes 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 passes to A's issue *per stirpes*. 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 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, 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 this case, Trust 1 was irrevocable on September 25, 1985, and it is represented that there have been no additions made after September 25, 1985. The beneficiaries have entered into an agreement with Son and Bank, as trustees, to reform Trust 1 to clarify and amend Trustees' investment responsibilities and to allow Bank to make adjustments between principal and income pursuant to State Statute 1 and State Statute 2, statutes similar to that described in § 26.2601-1(b)(4)(i)(D)(2) and § 26.2601-1(b)(4)(i)(E), *Example 12*. Therefore, the proposed administration of Trust 1 in accordance with State Statute 1 and State Statute 2 will not be considered to shift any beneficial interest in Trust 1 for GST purposes. Accordingly, based on the facts submitted and representations made, we conclude that if Bank makes adjustments between principal and income in accordance with Agreement and in accordance with and pursuant to State Statute 1 and State Statute 2, the proposed modification to Trust 1 will not adversely affect Trusts 1's status as exempt from GST tax. Further, we conclude that the other modifications to Trust 1 contained in Agreement are administrative in nature, and, therefore, are not considered to shift any beneficial interests in Trust 1. Thus, we conclude that the reformation of Trust 1 pursuant to Agreement will not adversely affect Trust 1's status as exempt from GST tax.

Ruling 5

Section 2501 imposes a tax on the transfer of property by gift during the calendar year by any individual.

Section 2511 provides that the gift tax 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 2514(b) provides that the exercise or release of a general power of appointment created after October 21, 1942, shall be deemed a transfer of property by the individual possessing the power.

Section 2514(c) provides that the term "general power of appointment" means a power that is exercisable in favor of the individual possessing the power, his estate, his creditors, or the creditors of his estate.

Section 25.2514-1(b)(1) of the Gift Tax Regulations provides, in part, that a power in a donee to remove or discharge a trustee and appoint himself may be a power of appointment. For example, if under the terms of a trust instrument, the trustee or his successor has the power to appoint the principal of the trust for the benefit of individuals including himself, and A, another person, has the unrestricted power to remove or discharge the trustee at any time and appoint any other person including himself, A is considered as having a power of appointment. However, the mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment.

As set forth above under Ruling 4, § 26.2601-1(b)(4)(i)(E), *Example 12,* concludes that where a trustee administers a trust in accordance with a state statute that permits the trustee to make adjustments between income and principal, no trust beneficiary will be treated as having made a gift for federal gift tax purposes. In addition, no beneficiary has a general power of appointment as defined in § 2514.

Consequently, based on the facts submitted and the representations made, we conclude that the reformation of Trust 1 pursuant to the agreement and the power of Bank to adjust between principal and income pursuant to State Statute 1 will not cause any beneficiary to have made a transfer of property for gift tax purposes.

Ruling 6

Section 2041(a)(2) provides that the value of the gross estate includes the value of all property to the extent of any property with respect to which the decedent has at the time of death a general power of appointment. Section 2041(b) defines the term "general power of appointment" as a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate, subject to certain exceptions.

Section 20.2041-1(b)(1) of the Estate Tax Regulations provides, in part, that if a trust instrument provides that the beneficiary may appropriate or consume the principal of the trust, the power to consume or appropriate is a power of appointment created after October 21, 1942. A power in a donee to remove or discharge a trustee and appoint himself may be a power of appointment. However, the mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment.

In this case, Bank is the only trustee with the power to make adjustments between income and principal under Agreement and State Statute 1. No beneficiary of Trust 1 has any power over Trust 1's assets other than the power of management and investment of assets. Neither Son nor any of the other beneficiaries has a power to replace Bank as trustee or appoint successor trustees. In the event of Son's resignation death or inability to serve as co-trustee, Bank becomes the sole trustee of Trust 1. Therefore, no beneficiary will be considered to have a general power of appointment under § 20.2041-1(b)(1).

Accordingly, based on the facts submitted and representations made, we conclude that the reformation of Trust 1 and Bank's powers to adjust between principal and income pursuant to Agreement and State Statute 1 will not cause any portion of Trust 1's assets to be included in a beneficiary's gross estate under § 2041.

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.

Except as specifically ruled herein, we express or imply no opinion on the federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code.

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.

Sincerely,

By: ________________________________
Leslie H. Finlow
Senior Technician Reviewer, Branch 4
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures
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cc: