

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact:

Telephone Number:

Refer Reply To:

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Date: OCTOBER 25, 2004

In Re:

LEGEND:

Decedent =
Spouse =
Son =
Trust =
Date 1 =
Date 2 =
Date 3 =
a =
State =
State Statute 1 =
State Statute 2 =

Dear _____ :

This is in response to your July 26, 2004 letter and other correspondence requesting a ruling concerning the generation-skipping transfer (GST) tax consequences of a proposed conversion of a trust.

You have requested the following ruling:

The proposed conversion of Trust into an a% unitrust will not give rise to a constructive addition to Trust nor otherwise cause Trust to lose its GST tax exempt status under section 2601 of the Internal Revenue Code.

The facts submitted are as follows:

Decedent executed his will on Date 1. Article Fifth of the will provides that if Spouse survives Decedent for a period of 60 days, Decedent devises the residue and remainder of his property, excluding property over which he has a power of appointment, to the trustees in Trust, for the uses and purposes and upon the terms and conditions hereinafter set forth:

A. The trustees shall collect and receive the income from the trust estate and shall pay the net income to or for the benefit of Spouse, Son, and the issue of Son at such times and in such amounts, equal or unequal, as the corporate trustee may in its sole discretion deem advisable.

B. Upon the death of Spouse, the corporate trustee shall continue to pay the net income to or for the benefit of Son and the issue of Son, at such times and in such amounts, equal or unequal, as the corporate trustee may in its sole discretion deem advisable.

C. Upon the death of Son, or in the event that Son shall predecease Spouse, then upon the death of Spouse, the corporate trustee shall divide the principal of the trust estate into as many equal shares as there shall be children of Son then living and children of Son then dead, represented by issue then living. The corporate trustee shall have no duty to adjust the shares so determined as a result of payments made under paragraphs A and B unless the trustee deems it advisable to do so. The trustee shall:

1. Distribute one such share to the issue then living of each such deceased child of Son, per stirpes, absolutely.
2. Hold one such share as a separate trust estate for the benefit of each such child of Son then living and apply so much of the income and principal as, in the sole discretion of the corporate trustee, it deems advisable for the support, education, maintenance, and health of such child and accumulate any unexpended balance of income and add the same to principal until such child attains the age of 21 years, and thereafter pay to such child the entire net income from the trust estate or the balance thereof, and so much of the principal as, in the sole discretion of the corporate trustee, is advisable for the support, education, maintenance, and health of such child. There shall be paid to such child, absolutely, from the principal of the trust estate, one-half thereof upon attaining the age of 30 years and the entire balance thereof upon attaining the age of 40 years.
3. If any child of Son shall have attained either of such respective ages at the time when such trust estate is directed to be set apart for such child or at the time when any share is added thereto, the corporate trustee shall then

distribute to such child such part or all, as the case may be, of such trust estate or of such added share as is directed to be paid to such child upon attaining such respective ages.

4. If any child of Son for whose benefit the corporate trustee holds a separate trust estate under paragraph 2 dies before attaining the age of 40 years, the principal of such trust estate shall be distributed, absolutely, to such child's then living issue, per stirpes, or if none, to my issue then living, per stirpes; provided, however, that any amount payable under this paragraph to a child of Son for whom at that time the corporate trustee holds a separate trust estate hereunder shall be added to the trust estate for such child for administration and distribution as a part thereof.

Decedent died on Date 2 (before September 25, 1985), survived by Spouse and Son. Spouse died on Date 3 (before September 25, 1985). The Trustee represents that there have been no actual or constructive additions to Trust after September 25, 1985.

The trustee has determined that converting Trust into an a% unitrust would enable the trustee to better carry out the intent of Decedent, as well as the overall purposes of Trust. The trustee proposes to convert Trust into a unitrust in accordance with State law.

State Statute 1 provides that unless expressly prohibited by the governing instrument, a trustee may release its power to adjust and convert a trust into a unitrust, if all of the following apply:

- (1) The trustee determines that the conversion will enable the trustee to better carry out the intent of the settlor or testator and the purposes of the trust.
- (2) The trustee gives written notice of the trustee's intention to release the power to adjust and to convert the trust into a unitrust and of how the unitrust will operate, including what initial decisions the trustee will make under this section, to all the sui juris beneficiaries who:
 - (i) are currently eligible to receive income from the trust; and
 - (ii) would receive, if no powers of appointment were exercised, a distribution of principal if the trust were to terminate immediately prior to the giving of notice.
- (3) There is at least one sui juris beneficiary under paragraph (2)(i) and at least one sui juris beneficiary under paragraph (2)(ii).

(4) No sui juris beneficiary objects to the conversion to a unitrust in a writing delivered to the trustee within 60 days of the mailing of the notice under paragraph (2).

State Statute 2 provides that after a trust is converted to unitrust, all of the following apply:

(1) The trustee shall follow an investment policy seeking a total return for the investments held by the trust, whether the return is to be derived: (i) from appreciation of capital; (ii) from earnings and distributions from capital; or (iii) from both.

(2) The trustee shall make regular distributions in accordance with the governing instrument construed in accordance with the provisions of this section.

(3) The term "income" in the governing instrument shall mean an annual distribution (the unitrust distribution) equal to $\underline{a}\%$ (the payout percentage) of the net fair market value of the trust's assets, whether such assets would be considered income or principal under other provisions of this chapter, averaged over the lesser of: (i) the three preceding years; or (ii) the period during which the trust has been in existence.

LAW AND ANALYSIS

Section 2601 of the Internal Revenue Code imposes a tax on every generation-skipping transfer (GST), which is defined under section 2611 as a taxable distribution, a taxable termination, or a direct skip.

Under section 1433 of the Tax Reform Act of 1986 (the Act), 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) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, except to the extent the transfer is made out of corpus added to the trust by an actual or constructive addition after 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 generation-skipping transfer tax under section 26.2601-1(b) will not cause the trust to lose its exempt status. These rules are applicable only for purposes of determining whether an exempt trust retains exempt status for generation-skipping transfer tax purposes. 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 GST tax 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 a beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a generation-skipping transfer or the creation of a new generation-skipping transfer.

Section 26.2601-1(b)(4)(i)(E), Example 11, illustrates a situation where a grantor established a trust in 1980. The trust 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. In 2002, State X 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. 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 the 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% 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. The conclusions in the example would be the same if the beneficiaries' consent was not required.

In this case, the proposed modification of Trust to provide for an a% unitrust, does not result in a shift of any beneficial interest in Trust to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the modification. See section 26.2601-1(b)(4)(i)(E), Example 11. Further, the modification does not extend the time for vesting of any beneficial interest in Trust beyond the period provided for in the original Trust.

Accordingly, based on the facts submitted and the representations made, we conclude that the proposed conversion of Trust into an a% unitrust will not give rise to a constructive addition to Trust nor otherwise cause Trust to lose its GST tax exempt status under section 2601.

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. We are specifically not ruling on the gift tax and income tax consequences of the transaction.

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 requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

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

Enclosure:

Copy of letter for section 6110 purposes