

## Internal Revenue Service

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### LEGEND:

Trust =

Decedent =

Year 1 =

Niece 1 =

Niece 2 =

Nephew 1 =

Nephew 2 =

Nephew 3 =

A =

B =

C =

D =

E =

F =

State Statute 1 =

State Statute 2 =

Dear :

This responds to your representative's letter dated December 29, 2006, requesting rulings on the income and generation-skipping transfer (GST) tax consequences of the proposed modification of Trust.

### FACTS

The facts and representations submitted are summarized as follows.

Trust was established under the will of Decedent in Year 1, a date prior to July 31, 1969. Under the terms of Trust, Niece 1, Niece 2, Nephew 1, Nephew 2, and Nephew 3 (Decedent's nieces and nephews) are each to receive an annuity of \$A out of the net

income of the trust. The remaining income of the trust each year is to be divided into six shares to be paid to six identified charitable organizations (the “charitable remaindermen”). Upon the death of Niece 1, Nephew 1, Nephew 2, or Nephew 3, the respective annuity of \$A allocable to that niece or nephew is payable to the lawful issue of that niece or nephew by right of representation. Upon the death of Niece 2, or upon the death of any named niece or nephew without any surviving lawful issue, his or her share of the net income will augment the amounts provided to be paid to the charitable remaindermen. Upon the death of the last survivor of the lawful issue of Niece 1, Nephew 1, Nephew 2, and Nephew 3 living at the time of Decedent’s death, the corpus of the trust and any undistributed income is to be distributed to the charitable remaindermen in equal shares.

Trust was funded with approximately \$B of assets. The assets of the trust are currently valued at \$C, more than four and one half times the original asset value. Because of the death of Niece 2 and the death of Nephew 2 without surviving issue, only three of the five annuities are currently being paid by the trust to the annuitant beneficiaries. Pursuant to the terms of trust, the remaining net income after payment of the annuities is being distributed in equal shares to the charitable remaindermen. Based on the life expectancy of the youngest measuring life, the trust is estimated to terminate 43 years from now. It is represented that only \$D, which is less than 4 percent of the value of the trust corpus, is necessary to fund the annuities for the expected duration of the trust.

Based on the foregoing, the charitable remaindermen obtained legal representation to pursue the acceleration of the charitable remainder interests. The charitable remaindermen noted that the total yearly annuity currently payable to the annuitant beneficiaries is only .1 percent of the value of the corpus of the trust and that the trustee’s fees each year are three times the amount of the annuities distributed. Under these circumstances, the charitable remaindermen have argued that no material purpose is served by continuing the Trust until the estimated termination date in 2051, and therefore, Trust should be fully or partially terminated.

After lengthy negotiations between counsel for the charitable remaindermen and counsel for the annuitant beneficiaries, the parties came to an agreement (the “Agreement”), as follows:

- a. Except to the extent of \$D, which is the amount required to fund the annuity payments for the remainder of Trust’s duration, Trust should terminate and the corpus should be distributed to the charitable remaindermen.
- b. Trust will continue to pay the annuities of \$A out of the Trust’s income each year to the annuitant beneficiaries and will continue to distribute any excess income each year to the charitable remaindermen as provided for under the original terms of Trust.

- c. Upon the final termination of Trust in accordance with the original terms of Trust, all of the then-remaining balance will be distributed outright to the charitable remaindermen in equal shares, as provided for under the original terms of Trust.
- d. The charitable remaindermen will purchase, separate and apart from the trust, commercial annuities for the benefit of each of the three annuitant families. Under the annuity contracts, an annuity amount of approximately \$E will be paid to each annuitant family for a term identical to the term of Trust, at a total cost to the charitable remaindermen of \$E. The charitable remaindermen have represented that each annuity policy to be purchased will remain the asset of the purchasing charity and the annuitants will have no rights to the annuity payments superior to those of the purchasing charity's other creditors.

Pursuant to the Agreement, counsel for the charitable remaindermen filed a petition for modification of Trust with the consent of all beneficiaries under the authority of State Statute 1.

State Statute 1 provides, in pertinent part:

- (a) Except as provided in (b), if all beneficiaries of an irrevocable trust consent, they may compel the modification or termination of the trust upon petition to the court.
- (b) If the continuance of the trust is necessary to carry out a material purpose of the trust, the trust cannot be modified or terminated unless the court, in its discretion, determines that the reason for doing so under the circumstances outweighs the interest in accomplishing a material purpose of the trust.

The petition attests that the non-petitioning beneficiaries as well as the petitioning beneficiaries have consented to the proposed modification.

You have requested the following rulings:

1. The implementation of the Agreement and court order will not cause Trust to lose its exempt status under § 1433(b)(2)(A) of the Tax Reform Act of 1986 and § 26.2601-1(b)(4)(i) of the Generation-Skipping Transfer Tax Regulations.
2. The partial termination of Trust and the early distribution to the charitable remaindermen will not result in the immediate realization of capital gain, capital loss or taxable income by the annuitant beneficiaries, the trust, or the charitable remaindermen.
3. The purchase of the commercial annuities by the charitable remaindermen for the benefit of the annuitant beneficiaries will not result in the immediate

realization of capital gain, capital loss or taxable income by the annuitant beneficiaries.

### Law and Analysis

#### Ruling 1

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

Under § 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 § 1433(b)(2)(A) of the Act and § 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 GST tax under § 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 GST 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 § 1001.

Section 26.2601-1(b)(4)(i)(D)(1) provides that a modification of the governing instrument by judicial reformation, or nonjudicial reformation that is valid under applicable state law 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 § 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, in part, that 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 GST or the creation of a new GST. 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.

In the present case, Trust was irrevocable on September 25, 1985. It is represented that no additions, actual or constructive, have been made to Trust after that date. Accordingly, Trust is exempt from the GST tax under § 26.2601-1(b)(1).

In measuring the effect of implementing the Agreement, we have determined that the interest of the annuitant beneficiaries in Trust will not change as a result of the implementation of the Agreement. The annuitant beneficiaries will receive the same amount under the terms of Trust as before implementation of the Agreement. Accordingly, provided the Agreement is valid under applicable state law, we conclude that implementing the Agreement will not result in a shift of any beneficial interest in Trust to any beneficiary who occupies a lower generation than the beneficiaries holding the beneficial interests prior to the modification. In addition, implementing the Agreement will not extend the time for vesting of any beneficial interests in the Trust beyond the period provided for in the Trust. Therefore, the Agreement will not affect the status of Trust as exempt from the GST tax under § 2601.

### Rulings 2 & 3

Section 61(a)(3) of the Internal Revenue Code provides that gross income includes gains derived from dealings in property and, under § 61(a)(15), from an interest in a trust.

Section 1001(a) provides that the 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 § 1011 for determining loss over the amount realized.

Section 1001(b) states 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(a) of the Income Tax Regulations provides that the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or loss sustained.

In Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), the Supreme Court considered whether a sale or exchange had taken place that resulted in realization of gain or loss under § 1001 when a financial institution exchanged its interests in one

group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans. The two groups of mortgages were considered "substantially identical" by the agency that regulated the financial institution. The Court concluded that § 1.1001-1 reasonably interprets § 1001(a). Id. at 560-61. The Court also stated that an exchange of property gives rise to a realization event under § 1001(a) if the properties exchanged are "materially different." 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. 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 interests in the loans. Id. at 566.

It is consistent with the Supreme Court's opinion in Cottage Savings to find that the interests of the annuitants and the six charities in Trust will not differ materially as a result of the proposed partial termination of Trust and the early distribution to the charitable remaindermen. The legal entitlements of the beneficiaries will not be changed. Each annuitant beneficiary's payment from Trust will remain unchanged. Only the timing of the receipt of a large portion of trust corpus by the charitable remaindermen will be modified. Except for the changes described above, all other provisions of Trust will remain unchanged. Accordingly, the modification of Trust to provide for the partial termination of Trust and the early distribution to the charitable remaindermen will not result in a material difference in kind or extent of the legal entitlements enjoyed by the beneficiaries, and no gain or loss will be recognized on the modification of Trust under § 1001(a).

As for the purchase of the annuities for the benefit of the annuitant beneficiaries, it is represented that each annuity policy to be purchased by the charitable remaindermen will remain the asset of the purchasing charity and the annuitant beneficiaries will have no rights to the annuity payments superior to those of the purchasing charities' other creditors. Accordingly, the purchase of the annuities by the charitable remaindermen for the benefit of the annuitant beneficiaries will not result in the immediate realization of capital gain, capital loss, or taxable income by the annuitant beneficiaries.

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.

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

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.

Sincerely,

James F. Hogan  
Senior Technician Reviewer, Branch 4  
Passthroughs & Special Industries

Enclosures

Copy for § 6110 purposes  
Copy of this letter