

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Date: APRIL 23, 2014

Legend

Husband
Proceeds Trust
Year 1
Year 2
Wife
Child 1
Child 2
Child 3
Child 4
Child 5
Child 6
Individual
Company
State 1
State 2
Property 1
Property 2
Date 1
Date 2
Date 3
Date 4
Agreement
Addendum

Statute 1
Statute 2
Statute 3

Dear :

This letter responds to your authorized representative's letter dated October 10, 2013, requesting rulings regarding the gift tax consequences of a proposed modification of the Proceeds Trust.

The facts and representations submitted are as follows:

In Year 1 and Year 2 (dates prior to October 8, 1990), Husband, Wife, and five of their six children (Child 1, Child 2, Child 3, Child 4, and Child 5) purchased Property 1, located in State 1, from an unrelated party for fair market value. On Date 1 (a date prior to October 8, 1990), Husband, Wife, and Children 1 through 5 executed an Agreement in connection with the Property 1 acquisition. In accordance with the terms of the Agreement, Husband, Wife, and Children 1 through 5 each paid the actuarial value of their respective interest from their own resources and none of the five children used any funds acquired from their parents to acquire their interests. Pursuant to the Agreement, Wife acquired a life interest in the use of and income from Property 1, Husband acquired a life interest in the use of and income from Property 1 that would become effective upon the death of Wife, Child 1 acquired a one-third common undivided interest in the remainder, and Children 2 through 5 each acquired a one-sixth common undivided interest in the remainder. Husband and Wife are referred to as "Life Tenants" and Children 1 through 5 are referred to as "Remaindermen."

Although Child 6 did not participate in the initial acquisition of Property 1 because he was a minor, Article 8 of the Agreement provides for the transfer of a one-sixth interest in the remainder estate from Child 1 to Child 6 upon Child 6's attainment of age 18. Consent by any party is not required provided that Child 6 agrees to be bound by the terms of the Agreement. On Date 2 (a date prior to October 8, 1990), Child 6 attained the age of majority and received his one-sixth interest by conveyance from Child 1.

On Date 3 (a date prior to October 8, 1990), the Life Tenants, the Remaindermen, and Child 6 executed an Addendum to the Agreement. The Addendum provides that Child 6 is added as a one-sixth Remainderman upon the transfer, pursuant to Article 8 of the Agreement, by his sister, Child 1, and that Child 6 agrees to be bound by all of the terms and conditions of the Agreement, as amended.

The Addendum further provides that Article 10 is added to the Agreement. Article 10 provides that in the event the Life Tenants and the Remaindermen agree to collectively acquire any subsequent real property as life tenants and remaindermen, the

newly-acquired property shall be subject to the same terms and conditions as between the Life Tenants and Remaindermen as set forth in the Agreement.

Subsequent to the execution of the Addendum, the Life Tenants and the Remaindermen acquired additional property located in State 1 in the same manner of holding title as they employed for Property 1. All of the properties so acquired, other than Property 1, are referred to as Property 2. The parties represent that they have not acquired any property as life tenants and remaindermen after October 8, 1990, and that the Agreement and the Addendum have not been modified or amended after October 8, 1990.

On Date 4 (a date after October 8, 1990), Property 1 was sold to an unrelated party and the proceeds were deposited in the Proceeds Trust. Article 5 of the Agreement provides, in part, that if Property 1 should be disposed of prior to the expiration of the respective life tenancies, the proceeds into which the property is converted shall be placed in trust, and the Life Tenants (or the survivor) shall be the trustees. Article 5 further provides that after the payment of income taxes, the remaining proceeds shall be held by the trustees, invested and reinvested, and the trustees shall pay to the Life Tenants, at least annually, all income (but not principal) earned by the trust assets. Upon the death of both of the Life Tenants, the trust shall terminate and the trust assets shall be immediately paid to the Remaindermen in accordance with their respective interests.

Also on Date 4, the Life Tenants, in their capacity as trustees pursuant to Article 5 of the Agreement, established the trust required to be created under Article 5 for the purpose of holding and administering the proceeds from the sale of Property 1. The trust is referred to as the Proceeds Trust and the instrument names the Life Tenants as the trustees of the Proceeds Trust.

The terms of the Proceeds Trust incorporate the dispositive terms of the Agreement. Paragraph 2 of the Proceeds Trust provides that the trustees shall invest and reinvest the proceeds and pay to the Life Tenants, at least annually, all income (but not principal or corpus), and upon the death of both Life Tenants, the trustees shall terminate the Proceeds Trust and distribute the remaining trust assets to the Remaindermen in accordance with their respective interests. Paragraph 3 provides that, to the extent not inconsistent with the Agreement, the trustees shall have all powers with respect to the Proceeds Trust and the trust property that are set forth under State 2 law and, in carrying out its fiduciary obligations, the trustees shall be bound by State 2 law. Paragraph 4 provides that except as provided in the Agreement, no person may add property to the Proceeds Trust, except that proceeds from a sale of Property 2, which is subject to the Agreement, may be added to the Proceeds Trust to the extent provided by the terms of the Agreement. Paragraph 5 provides that upon the death of either Life Tenant, the other Life Tenant shall serve as the sole trustee. Paragraph 6

provides that the Proceeds Trust is irrevocable and Paragraph 7 provides the trust situs is State 2.

On September 30, 2004, the Internal Revenue Service (Service) issued a private letter ruling to Husband regarding the applicability of § 2702 of the Internal Revenue Code (Code) to the sales transaction and the deposit of the proceeds in the Proceeds Trust. The ruling holds that the proceeds of a sale or other conveyance of Property 1, and the principal proceeds of any investments or reinvestments that are held in trust pursuant to the provisions of the Agreement will be treated as a transfer or transfers occurring prior to October 8, 1990, for purposes of applying the provisions of Chapter 14 of the Code and, therefore, Chapter 14 will not apply thereto. The ruling also holds that after the sale of Property 1, Property 2 will continue to be treated as property acquired pursuant to a transfer occurring prior to October 8, 1990.

Currently, the Life Tenants and the Remaindermen propose to modify the terms of the Proceeds Trust to appoint Individual as an independent trustee to serve with the Life Tenants as a co-trustee and to provide for the appointment of a successor independent trustee. The Modified Trust Agreement identifies Individual as the independent co-trustee of the Proceeds Trust and further specifies:

There shall at all times be serving a Trustee who is not a beneficiary of the Trust, and who either is a professional fiduciary or is an employee or principal of [Company], or its successor (an "Independent Trustee"). A "professional fiduciary" serving as Independent Trustee must be a bank or trust company that is qualified to act as a fiduciary under applicable federal or state law, or an attorney at law or a certified public accountant, none of whom is related or subordinate to any beneficiary within the meaning of [§ 672(c) of the Code].

In addition, the Modified Trust Agreement provides that the Life Tenants may appoint, in writing, a successor Independent Trustee upon the death, resignation, or incapacity of another Independent Trustee. The Life Tenants, by unanimous consent if both are then serving as trustees, or the remaining Life Tenant if one is then serving, together with a majority of the Remaindermen, shall have the right to remove any Independent Trustee appointed or serving. If at any time a party or parties remove an Independent Trustee, such party or parties shall appoint a successor Independent Trustee. If neither Life Tenant is then serving as trustee, the Remaindermen, by majority consent, shall have the right to appoint and to remove any Independent Trustee appointed or serving.

The Modified Trust Agreement makes no change to the distribution provisions or to the term of the Proceeds Trust.

Statute 1, a State 2 statute, provides that if the settlor and all beneficiaries consent to the modification or termination of an irrevocable trust, the court shall enter an order approving the modification or termination if the court finds that the modification or termination is in the best interests of the beneficiaries, even if the modification or termination is inconsistent with a material purpose of the trust.

Statute 2, a State 2 statute, provides, in relevant part, that a trustee may adjust between principal and income by allocating an amount of income to principal or an amount of principal to income to the extent the trustee considers appropriate if the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income. A trustee may not make an adjustment under this section if the trustee is a beneficiary of the trust.

Statute 3, a State 2 statute, provides, in relevant part, that unless expressly prohibited by the terms of the trust, a trustee may release the power to adjust under Statute 2 and convert a trust into a unitrust. The trustee must determine that the conversion will improve the ability of the trustee to carry out the intent of the settlor and the purposes of the trust. Statute 3 provides factors a trustee shall consider in making this determination. Statute 3 further requires the trustee to give, to the current income beneficiaries and the beneficiaries who would receive principal if the trust were to terminate and no power of appointment were exercised, 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. A trustee may not convert a trust into a unitrust if any beneficiary objects to the conversion to a unitrust in writing delivered to the trustee within 60 days of the mailing of the required notice. For a trust to convert to a unitrust, the trust must have at least one beneficiary eligible to receive income and at least one beneficiary who would receive principal if the trust were to terminate and no power of appointment were exercised. A trustee may not convert a trust into a unitrust if the trustee is a beneficiary of the trust.

Statute 3 further provides, in relevant part, that after a trust is converted to a unitrust, 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 from appreciation of capital, from earnings and distributions from capital or from both. The trustee shall make regular distributions in accordance with the terms of the trust construed in accordance with the provisions of this section. The term "income" in the terms of the trust means an annual distribution, known as the "unitrust distribution," equal to four percent, known as 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 Part of Statutes, averaged over the lesser of the three preceding years or the period during which the trust has been in existence.

It is represented that pursuant to Statute 2, the Independent Trustee of Proceeds Trust may adjust between principal and income of the Proceeds Trust by allocating an

amount of income to principal or an amount of principal to income to the extent the Independent Trustee considers appropriate. It is further represented that, pursuant to Statute 3, the Independent Trustee of the Proceeds Trust may release the power to adjust between principal and income and convert the Proceeds Trust into a unitrust if the requirements of Statute 3 are satisfied. The Life Tenants and the Remaindermen prefer that the Independent Trustee administer the trust in a manner that would involve the use of the power to adjust, or alternatively, to relinquish that power in favor of the unitrust approach to the computation of income. Accordingly, it is represented that the Life Tenants and the Remaindermen do not object to the Independent Trustee's prospective release of the power to adjust between principal and income and conversion of the Proceeds Trust to a unitrust.

You have requested the following rulings:

1. The Life Tenants and the Remaindermen will not be treated as making a taxable gift subject to Federal gift tax as a result of: (a) the agreement to modify the provisions of the Proceeds Trust pursuant to the Modified Trust Agreement; (b) the exercise by an Independent Trustee of the power to adjust between principal and income pursuant to Statute 2; (c) the exercise by an Independent Trustee of the power to release the power to adjust and convert the Proceeds Trust to a unitrust pursuant to Statute 3; and (d) the failure on the part of the Life Tenants and the Remaindermen to object to the conversion of the Proceeds Trust to a unitrust.
2. The agreement to modify the provisions of the Proceeds Trust pursuant to the Modified Trust Agreement, the exercise by an Independent Trustee of the power to adjust between principal and income pursuant to Statute 2, and the exercise by an Independent Trustee of the power to release the power to adjust and convert the Proceeds Trust to a unitrust pursuant to Statute 3 will not cause § 2702 to apply to the Proceeds Trust.

Law and Analysis

Ruling 1

Section 2501(a)(1) imposes a tax for each calendar year on the transfer of property by gift during such calendar year by an individual.

Section 2511(a) provides that the tax imposed by § 2501 shall apply whether the transfer is in trust or otherwise and whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.

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 such power.

Section 2514(c) provides that, subject to certain exceptions, a general power of appointment is a power that is exercisable in favor of the individual possessing the power (the possessor), 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 donee may have a power of appointment if he has the power to remove or discharge a trustee and appoint himself. For example, if under the terms of the 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 the fiduciary duties is not a power of appointment.

Section 643(b) of subtitle A of the Code provides that the term “income,” when not preceded by the words “taxable,” “distributable net,” “undistributed net,” or “gross,” means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law.

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 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 result in a taxable gift from the trust’s grantor or any of the trust’s beneficiaries. 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 non-judicial settlement) may result in taxable gifts from the trust's grantor and beneficiaries based on the relevant facts and circumstances.

In this case, Individual is the only trustee with the power, pursuant to Statute 2, to make adjustments between income and principal and, pursuant to Statute 3, to convert the Proceeds Trust to a unitrust. No beneficiary of the Proceeds Trust has any power over trust assets other than the power of management and investment of assets. Consequently, the shared power to remove an Independent Trustee and to appoint a successor Independent Trustee is not a general power of appointment within the meaning of § 2514. Accordingly, based on the facts submitted and the representations made, we conclude that the modification of the Proceeds Trust will not cause the Life Tenants and the Remaindermen to be treated as having made a taxable gift for Federal gift tax purposes.

Regarding the Independent Trustee's authority to adjust between income and principal pursuant to Statute 2, we conclude the exercise of the Independent Trustee's authority to adjust between principal and income pursuant to Statute 2 will not cause the Life Tenants or the Remaindermen to be treated as having made a taxable gift for gift tax purposes. Cf. Treas. Reg. § 26.2601-1(b)(4)(i)(E), Example 12 (although the example appears in the generation-skipping transfer tax regulations, the example concludes in relevant part 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).

Regarding the Independent Trustee's authority to convert the Proceeds Trust to a unitrust pursuant to Statute 3, we conclude that the conversion will not shift any beneficial interest in the Proceeds Trust. Accordingly, provided the proposed conversion meets the requirements of Statute 3, we conclude that the conversion of the Proceeds Trust pursuant to Statute 3 will not cause the Life Tenants or the Remaindermen to be treated as having made a taxable gift for gift tax purposes.

Since the conversion of the Proceeds Trust to a unitrust pursuant to Statute 3 will not shift any beneficial interest in the Proceeds Trust, we conclude that upon the Independent Trustee's notice of the intent to convert to a unitrust, the failure to object to the conversion will not cause the Life Tenants and the Remaindermen to be treated as having made a taxable gift for Federal gift tax purposes.

Ruling 2

The provisions of Chapter 14 of the Code (§§ 2701-2704), were added by the Revenue Reconciliation Act of 1990 and are effective for transfers occurring after October 8, 1990.

Section 2702(a)(1) provides, generally, that solely for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a member of the transferor's family is a gift (and the value of such transfer), the value of any interest in such trust retained by the transferor or any applicable family member shall be determined as provided in § 2702(a)(2).

Section 2702(a)(2) provides that the value of any retained interest which is not a qualified interest shall be treated as being zero. The value of any retained interests which is a qualified interest shall be determined under § 7520.

In the instant case, the Service has previously ruled in a private letter ruling to Husband that Chapter 14 does not apply to the sales transaction and deposit of the proceeds in the Proceeds Trust. The Life Tenants and the Remaindermen will have substantially identical interests both before and after the execution of the Modified Trust Agreement and the exercise of the Independent Trustee's authority under Statute 2 or Statute 3. The proposed modification of the Proceeds Trust and the exercise of the Independent Trustee's authority pursuant to Statute 2 and Statute 3 will not involve any transfer of an interest among the Life Tenants and the Remaindermen. Based on the facts submitted and representations made, we conclude the Modified Trust Agreement and the exercise of the Independent Trustee's authority pursuant to, and in accordance with, the requirements of Statute 2 and Statute 3, will not cause § 2702 to apply to the Proceeds Trust.

In accordance with the Power of Attorney on file with this office, we have sent a copy of this letter to your authorized representatives.

Except as expressly provided herein, we neither express nor imply any opinion 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 requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Karlene M. Lesho
Acting Senior Technician Reviewer, Branch 4
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure:

Copy for § 6110 purposes