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Department of the Treasury
Washington, DC 20224

Person To Contact:

, ID #

Telephone Number:

Refer Reply To:

CC:PSI:B09 – PLR-103649-03

Date:

December 31, 2003

Re:

LEGEND

Trustees =

Corporation =

State A =

Trust 1 =

Trust 2 =

Date 1 =

Settlors =

State B =

State B Citation 1 =

State B Statute 1 =

State B Court =

Dear :

This is in response to your letter dated December 31, 2002, submitted on behalf of Trustees, requesting a ruling regarding the income, gift, and generation-skipping transfer (GST) tax consequences of the proposed judicial modification of two trusts.

The information submitted and representations made are as follows: Corporation is the owner of certain residential real property (the "Property") located in State A. Corporation's stock is owned approximately by Trust 1 and approximately by Trust 2.

On Date 1, Settlers created Trust 1 for the benefit of their four children. Pursuant to Article II of Trust 1, the trust estate was divided into four equal trust shares, one for each child.

Article III, Paragraph 1(a) of Trust 1 provides, in part, that until the death of the last surviving child of Settlers, the trustee shall, after consulting with the respective beneficiaries of Trust 1 and Trust 2, allocate the use of Property owned by Corporation among the Settlers' children and the beneficiaries of Trust 2.

Article III, Paragraph 1(b) provides that each child possesses the testamentary power to appoint the principal of such child's separate share among any one or more of such child's creditors. To the extent that a child does not effectively exercise her testamentary power of appointment, the unappointed property shall be added to and commingled with the principal of Trust 2.

Article V permits the trustee to hold and operate shares in Corporation, to exercise voting rights with respect to Corporation, and to sell any property received from the Settlers or any other source at either public or private sale, for cash or on credit.

On Date 1, Settlers also created Trust 2 for the benefit of their grandchildren and great-grandchildren.

Article III, Paragraph 1(a) of Trust 2 provides, in part, that the trust estate shall be held as a single trust for the benefit of Settlers' grandchildren and great-grandchildren, including grandchildren and great-grandchildren born prior to the termination of Trust 2. During the term of the trust, the trustee shall, after consulting with the respective beneficiaries of Trust 1 and Trust 2, allocate the use of Property owned by Corporation among the various beneficiaries of Trust 1 and Trust 2.

Article III, Paragraph 1(b) provides that on the death of the last survivor of the named grandchildren and great-grandchildren, Trust 2 shall terminate and the trust estate shall be distributed to the Settlers' then living issue, per capita.

Article V permits the trustee to hold and operate shares in Corporation, to exercise voting rights with respect to Corporation, and to sell any property received from Settlers or any other source at either public or private sale, for cash or on credit.

Trustees represent that Trust 2 presently has an inclusion ratio of zero because of allocations of Settlers' GST exemptions that occurred each time property was transferred to Trust 2. Trustees further represent that there have been no additions, actual or constructive, to Trust 2 after the dates of the GST allocations to Trust 2.

The beneficiaries under Article III, Paragraph 1(a) of Trust 1 and Trust 2 (the "Beneficiaries") have determined that they no longer wish to use Property. As a result, Beneficiaries now seek to compel Trustees, pursuant to the authority granted under the terms of Trust 1 and Trust 2, to cause Corporation to dispose of Property and to invest the proceeds of sale into income-producing property. Because neither Trust 1 nor Trust 2 contains any provisions governing how the trusts will be administered if Property is converted into other assets, it will be impossible for Trustees to satisfy the dispositive provisions of Trust 1 and Trust 2 following the sale or other disposition of Property.

In light of the fact that Beneficiaries no longer wish to use Property, Trustees have a fiduciary obligation to cause the conversion of Property into productive assets. In addition, if Trustees compel Corporation to convert Property into income-producing assets, Trustees will be required to distribute the income to Beneficiaries in lieu of Beneficiaries' right to use Property pursuant to State B law. State B Citation 1. Thus, under State B law, a use interest in Trust 1 and Trust 2 is equivalent to an income interest in Trust 1 and Trust 2.

The conversion of Beneficiaries' income interests in Trust 1 and Trust 2 to unitrust interests is also supported by State B law. More specifically, State B Statute 1 provides, in part, that a trustee may convert an income trust to a total return unitrust if (i) the trustee adopts a written statement regarding trust distributions that provides that future distributions from the trust will be unitrust amounts rather than net income, and indicates the manner in which the unitrust amount will be calculated and the method in which the fair market value of the trust will be determined; and (ii) the percentage to be used to calculate the unitrust amount is not greater than 5% or less than 3%. State B Statute 1 further provides that if a trustee desires to convert an income trust to a total return unitrust, the trustee may petition the circuit court for such order as the trustee deems appropriate.

In accordance with the foregoing, Trustees have petitioned State B Court for an order (i) authorizing Trustees to cause Corporation to sell Property; (ii) directing Trustees to vote Trust 1 and Trust 2's shares in Corporation in a manner that will cause Corporation to distribute income to its shareholders at least annually; and (iii) modifying the terms of Trust 1 and Trust 2 to simultaneously convert Beneficiaries' interests in the trusts from use interests to income interests, and then from income interests to unitrust interests pursuant to State B law. The resulting trusts shall be referred to herein as "Restated Trust 1" and "Restated Trust 2."

Pursuant to Article III of Restated Trust 1, the trust estate will divide into four separate trust shares, one for each child.

Article III, Paragraph 1(a) of Restated Trust 1 provides generally that the trustee shall in each taxable year of each trust pay a unitrust amount equal to 3% of the net fair market value of the assets held in trust, valued as of the first day of the taxable year, to or for the benefit of each child (in cash, in kind, or partly in each).

Article III, Paragraph 1(e) of Restated Trust 1 provides that each child's separate trust shall terminate upon each child's respective date of death. In addition, each child possesses the testamentary power to appoint the principal of such child's separate share among any one or more of such child's creditors. To the extent that a child does not effectively exercise her testamentary power of appointment, the unappointed property shall be added to and commingled with the principal of Trust 2.

Article III of Restated Trust 2 provides that the trust estate will be held for the benefit of the Settlor's grandchildren and great-grandchildren, including grandchildren and great-grandchildren born prior to the termination of Trust 2.

Article III, Paragraph 1(a) of Restated Trust 2 provides generally that the trustee shall in each taxable year of the trust pay a unitrust amount equal to 3% of the net fair market value of the assets held in trust valued as of the first day of the taxable year to or for the benefit of the beneficiaries (in cash, in kind, or partly in each).

Article III, Paragraph 2 of Restated Trust 2 provides that on the death of the last survivor of the named grandchildren and great-grandchildren, Trust 2 shall terminate and the trust estate shall be distributed to the Settlor's then living issue, per capita.

Upon court approval of the proposed modifications to Trust 1 and Trust 2, Corporation will file Form 2553 to be treated as an S corporation pursuant to §1361(a). Each trust share of Restated Trust 1 will file an election to be treated as an electing small business trust ("ESBT") pursuant to §1361(d). Restated Trust 2 will file an ESBT election pursuant to § 1361(d).

Trustees represent that: Trust 1 and Trust 2 have not made elections to be qualified subchapter S trusts; Trust 1 and Trust 2 are not exempt from tax under subtitle A of the Code; and each beneficiary of Trust 1 and Trust 2 is an individual.

Trustees request the following rulings:

1. The proposed judicial modification of Trust 2 will not adversely affect Trust 2's zero inclusion ratio attributable to the GST exemption previously allocated thereto.
2. The proposed judicial modification of Trust 1 and Trust 2 will not cause either trust to be subject to federal gift tax under § 2501.
3. The proposed judicial modification of Trust 1 and Trust 2 will not cause there to be a disposition under either trust for purposes of § 1001 and therefore will not result in the recognition of gain or loss.
4. The four equal trust shares of Restated Trust 1 and Restated Trust 2, satisfy the requirements of § 1361(e)(1).

RULING 1

Section 2601 imposes a tax on every generation-skipping transfer. Section 2611(a) defines the term "generation-skipping transfer" as a taxable distribution, a taxable termination, and a direct skip.

Under § 1433(b)(2)(A) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the generation-skipping transfer tax provisions do not apply to any generation skipping transfer under a trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985. However, this exemption does not apply if additions (actual or constructive) are made to the trust after September 25, 1985.

Section 2631(a) provides that for purposes of determining the inclusion ratio, every individual shall be allowed a GST exemption of \$1,000,000 which may be allocated by such individual (or his executor) to any property with respect to which such individual is the transferor.

Section 2632(c)(1) provides that any portion of an individual's GST exemption that has not been allocated within the time prescribed by § 2632(a) shall be deemed to be allocated as follows – (A) first, to property that is the subject of a direct skip occurring at such individual's death, and (B) second, to trusts with respect to which such

individual is the transferor and from which a taxable distribution or a taxable termination might occur at or after such individual's death.

Section 2654(b)(1) provides that the portions of a trust attributable to transfers from different transferors shall be treated as separate trusts.

Section 26.2601-1(b)(1)(ii)(A) provides, generally, that any trust in existence on September 25, 1985, will be considered an irrevocable trust unless otherwise provided in § 26.2601-1(b)(ii)(B) or (C), relating to property includible in a grantor's gross estate under §§ 2038 and 2042.

Section 26.2601-1(b)(4) 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 § 26.2601-1(b)(1), (2), or (3) (hereinafter referred to as an exempt trust) will not cause the trust to lose its exempt status. The rules contained in § 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its 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 § 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) of this section) 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 in the original trust.

Section 26.2601-1(b)(4)(i)(D)(2) provides that, for purposes of this section, 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)(E), Example 11, considers a situation where a trust that is otherwise exempt from the GST tax 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. State X, the situs of the trust, then 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. The example concludes that the administration of the trust, in accordance with the state statute defining the income to be a 4% unitrust amount will not be considered to shift a beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13. Further, under the facts of the example, 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.

The Supreme Court of State B has determined that upon the conversion of residential real property held in trust into income-producing assets, the trustee must distribute the income to the trust beneficiaries in lieu of the beneficiaries' right to use the real property. State B Citation 1.

In addition, State B Statute 1 provides, in part, that a trustee may convert an income trust to a total return unitrust if (i) the trustee adopts a written statement regarding trust distributions that provides that future distributions from the trust will be unitrust amounts rather than net income, and indicates the manner in which the unitrust amount will be calculated and the method in which the fair market value of the trust will be determined; and (ii) the percentage to be used to calculate the unitrust amount is not greater than 5% or less than 3%. State B Statute 1 further provides that with regard to residential property that, as of the first business day of the current valuation year, one or more beneficiaries of the trust have a right to occupy or possess, the right to possession and control shall be deemed to be the unitrust amount with respect to such property.

No guidance has been issued concerning judicial modifications that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption

was allocated to the trust to result in an inclusion ratio of zero. At a minimum, a modification that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of such a trust.

In this case, the terms of Trust 1 and Trust 2 provide that until the death of the survivor of Beneficiaries, the trustee shall allocate the use of Property owned by Corporation among Beneficiaries. Trustees have petitioned State B Court for an order modifying the terms of Trust 1 and Trust 2 to convert Beneficiaries' use interests in the trusts to income interests, and then convert Beneficiaries' income interests to unitrust interests pursuant to State B law.

In State B, upon the conversion of residential real property held in trust into income-producing assets, the trustee must distribute the income to the trust beneficiaries in lieu of the beneficiaries' right to use the real property. See State B Citation 1. Thus, Beneficiaries' use interests in Property are equivalent to income interests in that property under State B law. Furthermore, pursuant to §§ 26.2601-1(b)(4)(D)(2) and 26.2601-1(b)(4)(E), Example 11, the conversion of Beneficiaries income interests into unitrust interests in conformance State B Statute 1 will not be considered to shift a beneficial interest in the trust.

Based on the foregoing, we conclude that the proposed judicial modification of Trust 2 will not adversely affect Trust 2's zero inclusion ratio and that Trust 2 (and Restated Trust 2) will continue to be exempt from the GST tax.

RULING 2

Section 2501(a) imposes a tax for each calendar year on the transfer of property by gift during the calendar year by any individual, resident or nonresident.

Section 2511(a) provides that the tax imposed by § 2501 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 2512(a) provides that if the gift is made in property, the value thereof at the date of the gift is considered the amount of the gift.

Section 2512(b) provides that where property is transferred for less than adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration is deemed to be a gift, and is included in computing the amount of gifts made during the calendar year.

In this case, the proposed judicial modifications to Trust 1 and Trust 2 are consistent with applicable state law that would be applied by the highest court of

State B. Because Beneficiaries will have the same beneficial interest in Trust 1 and Trust 2 following the proposed modification as they had prior to any modification, no transfer of property will be deemed to occur. Therefore, we conclude that the proposed judicial modifications of Trust 1 and Trust 2 will not cause a direct or indirect transfer of property. Accordingly, the proposed judicial modifications do not constitute taxable gifts under § 2501.

RULING 3

Section 61(a)(3) provides that gross income includes gains derived from dealings in property. Under § 1.61-1(a), gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services.

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), 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.

The conversion of Trust 1 and Trust 2 from use trusts to income trusts results from the exercise by Trustees' of their authority to dispose of Property under the trust documents and therefore there is no sale or other disposition under § 1001 of a trust interest by any beneficiary. The court order being sought will amend the terms of the trusts to reflect their new status as income trusts. In addition, the conversion of Trust 1 and Trust 2 from income trusts to unitrusts by a court-approved exercise of the trustee's authority to make the conversion under State B Statute 1 is not a sale or other disposition under § 1001 of a trust interest by any beneficiary.

RULING 4

Section 1361(a) provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect.

Section 1361(b)(1) provides that the term "small business trust" means a domestic corporation which is not an ineligible corporation and which does not (A) have more than 75 shareholders (B) have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2)), or an organization described in § 1361(c)(6), (C) have a nonresident alien as a shareholder, and (D) more than one class of stock.

Under § 1361(c)(2)(A)(v), an electing small business trust is an eligible shareholder of an S corporation. Section 1361(e) defines electing small business trust.

Section 1361(e)(1)(A) provides that, except as provided in § 1361(e)(1)(8), the term "electing small business trust" means any trust if - (i) such trust does not have as a beneficiary any person other than an individual, an estate, or an organization described in paragraph (2), (3), (4), or (5) of § 170(c), (ii) no interest in such trust was acquired by purchase, and (iii) an election under § 1361(e) applies to such trust.

Section 1361(e)(1)(8) provides that the term "electing small business trust" shall not include - (i) any qualified subchapter S trust (as defined in § 1361(d)(3)) if an election under § 1361(d)(2) applies to any corporation the stock of which is held by such trust, (ii) any trust exempt from tax under subtitle A of chapter 1, and (iii) any trust exempt from tax under subtitle A of chapter 1, and (iii) any charitable remainder annuity trust or charitable remainder unitrust (as defined in § 644(d)).

Section 1361(e)(2) provides that for purposes of § 1361(c), the term "potential current beneficiary" means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person, may receive, a distribution from the principal or income of the trust.

Notice 97-49, 1997-2 C.B. 304, provides that for purposes of § 361(e)(1)(A)(i), the term beneficiary does not include a distributee trust, but does include those persons who have a beneficial interest in the property held by the distributee trust. Furthermore, the Notice provides that for purposes of § 1361(e)(2) if a distributee trust becomes entitled to, or at the discretion of any person may receive, a distribution from principal or income of the ESBT, then the trust will become a potential current beneficiary and the S corporation election will terminate unless the distributee trust is a trust described in § 1361(c)(2)(A).

Based on the representations made, the information provided, and the assumption that the interest of any contingent charitable beneficiary of the trusts described in § 170(c) is so remote as to be negligible and that such contingent charitable beneficiaries are therefore not beneficiaries of Restated Trust 1 and Restated Trust 2 as described in § 1361(e)(1)(A), we conclude that the beneficiaries of Restated Trust 1 and Restated Trust 2 individuals and are qualified beneficiaries.

Accordingly, upon the four equal trust shares of Restated Trust 1, and Restated Trust 2, making valid and timely elections under § 1361(e)(3), the trusts will satisfy the requirements of § 1361(e)(1).

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.

This ruling is directed only to the taxpayers requesting it. Section 6110(k)(3) 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 taxpayer.

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

James F. Hogan
Acting Branch Chief, Branch 9
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosure

Copy for 6110 purposes