

Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:4-PLR-126221-01

Date:
APRIL 03, 2002

Re:

Legend:

Trust =

Decedent =

Child 1 =

Child 2 =

Child 3 =

Date 1 =

Date 2 =

Date 3 =

Court =

State =

Dear :

This is in response to your letter dated May 4, 2001, in which a ruling was requested concerning the generation-skipping transfer tax consequences of a proposed modification of Trust.

Decedent died testate on Date 1, survived by his three children, Child 1, Child 2, and Child 3. Under Decedent's will, dated Date 2, Decedent established a testamentary Trust for the primary benefit of Child 3 and Child 3's children. The trustees are required to pay the Trust income quarterly to Child 3 for life. The will further provides:

I also appoint [Child 1] and [Child 2] be appointed trustees of the trust of [Child 3] without bond and make any distribution of the Principal as they think proper and necessary for the comfort of her or her children. At the death of [Child 3] the trust fund will pass on to her children and the same trustees will continue to handle the trust for the children until they think time is proper to pay the trust fund to the children or any part thereof.

Section 55-19.4 of the 1950 Code of State, as amended, provides that upon the petition of the trustee or a beneficiary of a trust, in the circuit court in which the trustee qualified, such circuit court may, for good cause shown, modify a trust in any manner or terminate the trust and order distribution of the trust property.

Child 3, age 73, has two children, ages 39 and 42. A State court order has determined that the reference in the will to Child 3's children does not include adopted children and refers only to her two natural children. Therefore, the court has determined that Child 3's two children have vested remainders in the trust. The current trustees, Child 1 and Child 2, of trust, in a petition filed with the court, stated that they would exercise the powers conferred upon them under the will to distribute the trust assets outright in equal shares to Child 3's children if Child 3 was deceased.

Therefore, a State court has approved a modification of the Trust under which the Trust is to be terminated and the assets transferred to a new inter irrevocable inter vivos trust with Child 3 as trustee. The terms of Trust and of the new trust are to be identical except that (1) under the new trust the power of any beneficiary surviving as trustee to distribute trust principal to himself or herself shall be exercisable only for his or her health, education, and support, as provided in § 64.1-67.2 of the 1950 Code of State, as amended, (ii) the assets of the new trust, upon Child 3's death, will be distributed equally to Child 3's two children, or the estate of a deceased child, and (iii) the current trustees will be discharged and Child 3 will be appointed as the trustee of the new trust. The court determined that this modification was a proper construction of the provisions of the will on the basis of applicable State law and the position taken by the trustees, i.e., that they would exercise the powers conferred upon them under the will to distribute Trust assets outright in equal shares to the children if Child 3 were deceased. The order was issued Date 3.

In the present case, Trust was irrevocable on September 25, 1985 and no additions, actual or constructive, have been made to Trust after that date. You have requested the following rulings:

1. That the proposed distribution of Trust's assets to the new trust will not cause Trust, the new trust, or any beneficiary to recognize gain or loss under §§ 61 and 1001 of the Internal Revenue Code.
2. That each asset transferred to the new trust from Trust will have the same basis and holding period under §§ 1015 and 1223 in the hands of the new trust as each asset had at the time of the transfer.
3. That the proposed modifications and construction do not cause Trust to lose its exempt status under § 2601.
4. That the beneficiaries of Trust or the new trust have not made a gift as a result of the proposed modifications and construction of Trust and the assets of Trust and the successor trust will not be includible in the gross estate of Child 3 under § 2041.

Ruling Request 1 and 2

Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

Section 1001(a) provides that the gain from the sale or other disposition of property will be the excess of the amount realized from the sale over the adjusted basis provided in § 1011 for determining gain, and the loss will be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

Section 1.1001-1(a) of the Income Tax Regulations provides that except as otherwise provided in subtitle A of the Code, 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 as loss sustained.

An exchange of property results in the realization of gain or loss under § 1001 if the properties exchanged are materially different. Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991). There is a material difference when the exchange properties embody legal entitlements "different in kind or extent" or if they confer "different rights and powers." 499 U.S. at 565.

In Rev. Rul. 69-486, 1969-2 C.B. 159, a non-pro rata distribution of trust property was made in kind by the trustee, although the trust instrument and local law did not give the trustee authority to make a non-pro rata distribution of property in kind. The distribution was effected as a result of a mutual agreement among the trustees and the beneficiaries. Because neither the trust instrument nor local law conveyed authority to the trustee to make a non-pro rata distribution, Rev. Rul. 69-486 holds that the transaction was equivalent to a pro rata distribution followed by an exchange between the beneficiaries and was subject to the provisions of §§ 1001 and 1002.

Here the original trust instrument conveys authority to the trustees to make any distribution of the principal as they think proper and necessary for the comfort of Child 3 or her children. Therefore, a modification of Trust under which one-half of the assets go to each child of Child 3 upon the death of Child 3 is within the authority of the original trust instrument, and does not constitute an exchange within the meaning of § 1001. Similarly, the restriction of the power of any beneficiary serving as trustee to distribute trust principal to himself or herself only for his or her health, education, and support, as provided in § 64.1-67.2 of the 1950 Code of State, as amended, is within the authority of the original trust instrument, and does not constitute an exchange within the meaning of § 1001.

Based on the information submitted and the representations made in the ruling request, the beneficiaries will possess the same interests before and after the trust modification. Therefore, under Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), any properties exchanged are not materially different, and there is no realization of gain or loss. Accordingly, the proposed distribution of Trust's assets to the new trust

does not cause Trust, the new trust, or any beneficiary to recognize gain or loss under §§ 61 and 1001.

Section 1015(b) provides that if property is acquired after December 31, 1920, by a transfer in trust (other than by a transfer in trust by gift, bequest, or devise), the basis is the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on the transfer under the law applicable to the year in which the transfer is made.

Section 1.1015-2(a)(1) provides that in the case of property acquired after December 31, 1920, by transfer in trust (other than by transfer in trust by gift, bequest, or devise) the basis of property so acquired is the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on the transfer under the law applicable to the year in which the transfer was made. If the taxpayer acquired the property by transfer in trust, this basis applies whether the property be in the hands of the trustee, or the beneficiary, and whether acquired prior to termination of the trust and distribution of the property, or thereafter.

Section 1223(2) provides that, in determining the period for which the taxpayer has held property however acquired, there shall be included the period for which the property was held by any other person, if such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in the taxpayer's hands as it would have in the hands of such other person.

Accordingly, we conclude that the basis of the assets in the new trust will be same as the basis of those assets in Trust before the transfer. In addition, we conclude under § 1223(2) the new trust's holding period for an asset transferred to it by Trust will include Trust's holding period for the asset at the time of the transfer.

Ruling Request 3

Section 2601 imposes a tax on every generation-skipping transfer made by a transferor to a skip person.

Under § 1433(a) of the Tax Reform Act of 1986, the generation-skipping transfer tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) of the Tax Reform Act and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to any generation-skipping transfer from a trust, if the trust was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date. Under § 26.2601-1(b)(1)(ii), any trust in existence on September 25, 1985, will be considered irrevocable unless the settlor had a power that would have caused inclusion of the trust in his or her gross estate under § 2038 or 2042, if the settlor 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 generation-skipping transfer tax will not cause the trust to lose its exempt status. The regulation provides that the rules contained in the paragraph 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) and (2) provides that a modification 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. A modification will not result in the shift of a beneficial interest to a lower generation beneficiary if the modification does not result in an increase in the amount of a GST transfer or the creation of a new GST transfer.

In the present case, the proposed modifications and construction of Trust will 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 modification. Further, the proposed modification will not extend the time for vesting of any beneficial interest in the Trust beyond the period provided for in Trust. Accordingly, based on the facts submitted and the representations made, the proposed modification will not cause Trust or the new trust to lose its exempt status for purposes of the generation-skipping transfer tax under § 2601.

Ruling Request 4

Section 2501(a)(1) imposes a gift tax on the transfer of property by gift. Section 2511(a) provides that the gift tax shall apply 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 2041(a)(2) provides that the value of the gross estate shall include 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 created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition that is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under §§ 2035 to 2038, inclusive.

Section 2041(b)(1)(A) provides that a general power of appointment is a power that is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate; however, a power to consume, invade, or appropriate property for the benefit

of the decedent that is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent is not deemed to be a general power of appointment.

Section 2041(b)(2) provides that the lapse of a power of appointment created after October 21, 1942, is considered a release of the power.

In the present case, as construed by the State court, each beneficiary has the same interest before and after the transfer to the new trust. Accordingly, the beneficiaries of Trust or the new trust have not made a gift as a result of the proposed modifications and construction. In addition, the assets of Trust are not included in the gross estate of Child 3 because only the trustees, not Child 3, who was not a trustee, possessed the power to distribute principal to Child 3. Furthermore, as trustee of the new trust, any discretion to distribute corpus to herself is limited by an ascertainable standard and is not a general power of appointment. Accordingly, the assets of the new trust will not be includible in the gross estate of Child 3.

The ruling contained in this letter is 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 the ruling, it is subject to verification on examination.

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

The 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 yours,
Lorraine E. Gardner
Assistant to the Branch Chief, Branch 4
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure

Copy for section 6110 purposes

cc: