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Legend:

Trust =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =

Year =

Decedent =
Spouse =

Daughter =

State Law 1 =
State Law 2 =
State Law 3 =

State =

Dear :

This letter is in response to a letter dated June 9, 2005 from your authorized representative requesting rulings concerning the income and generation-skipping transfer tax consequences of Trustee's discretion in allocating receipts from royalties pursuant to the authority granted under Trust and State law.

The facts and representations submitted are summarized as follows: Decedent executed a will on Date 1. Decedent died on Date 2 survived by Spouse and Daughter. Spouse died on Date 3. Under Article V of Decedent's will, Decedent established Trust for the benefit of Daughter and any child or grandchild of Daughter. Daughter has two children over the age of thirty. The trustee is an independent trustee. There have been no additions, actual or constructive, to Trust since September 25, 1985.

Article V(2) of Decedent's will provides that after the death of Spouse, if Daughter is then surviving, the trustee is to pay the net income of Trust to Daughter for the remainder of Daughter's life. During the life of Daughter, the trustee, in its discretion, may use any portion of the corpus of Trust for the proper care and support of Daughter or any child or grandchild of Daughter, or the education of any such child or grandchild.

Article V(3) and (4) of Decedent's will provide that at Daughter's death, the property of Trust will be held in further trust until each grandchild attains the age of thirty years, at which time it will be distributed outright to such grandchild. Trust is to terminate no later than 21 years after the death of the last to die of Spouse, Daughter and grandchildren living at Decedent's death.

Article V(7) of Decedent's will provides that each trust is to be administered in accordance with the provisions of State law as it exists on the date Decedent executed the will, regardless of whether State law may be repealed or amended; provided, that the trustee, at its option, may exercise any additional powers conferred on trustee of such trust by any subsequent amendment of State law.

State Law 1, as it existed at the date of Decedent's will, states:

> Where any part of the principal consists of any interest in lands, including royalties, overriding royalties, and working interest, from which may be taken timber, minerals, oil, gas or other natural resources, and the trustee or tenant is authorized by law or by the terms of the transaction by which the principal or trust was established to sell, lease, or otherwise develop such natural resources, and no provision is made for the disposition of the proceeds thereof, such proceeds, if received as delay rentals on a lease shall be deemed income, but if received as consideration, whether as bonus or consideration for the execution of the lease or as royalties, overriding or limited royalties, oil payments or other similar payments, received in connection with physical severance of natural resources, shall be apportioned to principal and income as follows: 27½% of the gross proceeds (but not to exceed 50% of the net, after deducting the expense and carrying charges on such property) shall be treated as principal and invested or held for the use and benefit of the remainderman, and the balance shall be treated as income subject to be disbursed to the tenant or person entitled thereto.

In Year, State Law 1 was amended by the adoption of State Law 2. On Date 4, State Law 2 was amended to adopt a modified version of the Uniform Principal and Income Act. State Law 2 provides that if an amount received as a royalty, shut-in well payment, take-or-pay payment, bonus or delay rental is more than nominal, the trustee is to allocate the receipt equitably. Under State Law 2, the trustee may allocate a receipt from any interest in minerals, water, or other natural resources the trust owns on Date 4, in the manner provided under State Law 2 or in any lawful manner used by the trustee before Date 4, to make the same allocation. The trustee is to allocate a receipt from any interest in minerals, water, or other natural resources acquired by the trust after Date 4, in the manner provided under State Law 2.

State Law 3 provides that if a trust has two or more beneficiaries, the trustee is to act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.

The oil and gas royalty interests held by Trust acquired prior to Date 4 constitute a significant part of the assets of Trust. Under Decedent's will, the trustee had no discretion as to how to allocate receipts from the royalties because State law, as it existed at the time of the will, directed the royalty receipts to be apportioned 27.5% as principal and the remaining 72.5% as income. This recently changed when State adopted modified versions of the Uniform Principal and Income Act and the Uniform Prudent Investor Act. Effective Date 4, State Law 2 provides that if an amount received as a royalty is more than nominal, the trustee is to allocate receipts equitably. For royalty interests held by the trust on Date 4, the trustee is authorized, but not required, to continue the same method of allocation in use prior to Date 4.

An independent engineering appraisal report on Date 5 indicates that the royalty interests and recoverable reserves of Trust have declined over the years and continue to rapidly decline. The trustee has determined that under the circumstances presently existing, it would be equitable, subject to a favorable letter ruling, to allocate 90% of receipts to principal and 10% to income. This allocation is consistent with the allocation required under section 411(a)(3) of the Uniform Principal and Income Act. The decision by the trustee is designed to achieve impartiality by making up for excess allocations to income in earlier years because the trustee had no discretion in the allocation of royalty receipts. The trustee will periodically review the proposed allocation of 90%-10% to ensure that its administration of Trust complies with its statutory duty of impartiality in accordance with State Law 3.

The trustee requests the following rulings:

1. The trustee's proposed exercise of discretion in allocating receipts from royalties, pursuant to the authority granted by Trust and State Law 2, will not result in Trust's loss of generation-skipping transfer tax exempt status.

2. The trustee's proposed exercise of discretion in allocating receipts from royalties, pursuant to the authority granted by Trust and State Law 2, will not result in a recognition of income under § 1001.

Ruling Request 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 section 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 section 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 a 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 under § 26.2601-1(b) 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)(C) provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to be subject to the GST provisions, if: (1) the judicial action involves a bona fide issue; and (2) the construction is consistent with applicable state law that would be applied by the highest court of the state.

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 § 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. 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 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 the 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)(i)(E), Example 12, 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 permit the trustee to make adjustments between income and principal when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding allocation of receipts between income and principal is unable to administer the trust impartially. The provision permitting the trustees to make these adjustments is effective in 2002 for trust created at any time. The trustee invests and manages the trust assets under the state's prudent investor standard, and pursuant to authorization in the state statute, the trustee allocates receipts between the income and principal accounts in a manner to ensure the impartial administration of the trust. The administration of the trust in accordance with the state statute 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 of the Internal Revenue Code. Further, under these facts, 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. Similarly, the conclusions in this example would be the same if the change in administration of the trust occurred because the situs of the trust was changed to State X from a state whose statute does not authorize the trustee to make adjustments between income and principal or if the situs was changed to such a state from State X.

In the present case, the trustee's proposed allocation of receipts under State law is substantially similar to the situation described in Example 12 of § 26.2601-1(b)(4)(i)(E) and, thus, will not result in a shift of any beneficial interest to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the allocation. Further, the allocation 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 trustee's proposed exercise of discretion in allocating receipts from mineral royalties, pursuant to the authority granted by Trust and State Law 2, will not result in Trust's loss of generation-skipping transfer tax exempt status.

Ruling Request 2

Section 61 of the Internal Revenue Code provides that gross income means all income from whatever source derived. 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 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. Section 1001(b) provides 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. Section 1001(c) provides that, except as otherwise provided in subtitle A, the entire amount of the 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 as loss sustained.

Rev. Rul. 56-437, 1956-2 C.B. 507, holds that the severance of a joint tenancy in stock under a partition action provided for by state law to compel the issuance of separate stock certificates is not a sale or exchange. Likewise the conversion of a joint tenancy in stock into a tenancy in common in order to extinguish the survivorship feature is a nontaxable transaction because the right of the property owners to partition is an inherent ownership right each party possessed under applicable state law.

Rev. Rul. 69-486, 1969-2 C.B. 159, involved two beneficiaries of a trust who by mutual agreement, requested that the trustee distribute all of the trust corpus consisting of notes to one of the beneficiaries and all of the trust corpus consisting of common stock to the other beneficiary. The trust instrument as well as local law was silent regarding whether the trustee had the authority to make such a non-pro rata distribution of property in kind. Because the trustee was not specifically authorized to make an allocation of specific property in kind, the beneficiaries were treated as having an absolute right to a ratable in-kind distribution. Rev. Rul. 69-486 treated the beneficiaries as receiving the notes and common stock pro rata, followed by an exchange between the beneficiaries giving all of the common stock to one and all of the notes to the other. Since, in substance, an exchange between the beneficiaries was deemed to occur, Rev. Rul. 69-486 held that the beneficiaries recognized gain under §§ 1001 and 1002.

In Cottage Savings Assoc. v. Commissioner, 499 U.S. 554 (1991), the Supreme Court addressed whether a sale or exchange has taken place that results in a

realization of gain or loss under § 1001. The Court stated that an exchange of property gives rise to a realization event under § 1001(a) if the properties exchanged are materially different. Consequently, the Court held that an exchange of mortgages constituted a realization event under § 1001(a) of the Code because the exchanged interests - loans that were made to different obligors and secured by different homes - were legally distinct entitlements. Thus, in order for a transaction to result in a § 1001 taxable event, the transaction must be (1) a sale, exchange, or other disposition and (2) if an exchange, the exchange must result in the receipt of property that is materially different from the relinquished property.

In the present case, the beneficiaries do not acquire their interests in Trust as a result of an exchange, but instead the trustee is merely exercising the trustee's existing authority under the will to exercise any additional powers conferred as a result of the change to State law. The change to State law, in this case, allows the trustee to modify the allocation of royalty receipts between income and principal. Because the proposed modification in the allocation of gross receipts from royalties is not an exchange, there is no receipt of property that is materially different in legal entitlements from the relinquished property.

This case is similar to the transaction in Rev. Rul. 56-437 in which the joint owners of property exercised a right inherent in their ownership rights in the property to partition the property. Furthermore, the present case is distinguishable from Rev. Rul. 69-486 because the will and applicable State law gives the trustee the discretion to allocate receipts from royalties in any manner so long as it is equitable to both income and remainder beneficiaries. Therefore, the proposed modification to allocate royalty receipts equitably between the income beneficiary and the remainder beneficiaries will result in the realization of income to neither Trust nor the beneficiaries under §1001 or Cottage Savings.

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.

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

Each 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,

Lorraine E. Gardner
Senior Counsel, Branch 4
(Passthroughs & Special Industries)

Enclosures
Copy for section 6110 purposes
Copy of this letter