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COMMITTEE ON ESTATE AND GIFT TAXATION

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January 31, 2003

Internal Revenue Service
CC: M&SP:RU (REG-106513-00)
Room 5226
P. O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Comments of the Committee on Estate and Gift Taxation of The Association of the Bar of the City of New York on the Proposed Regulations Revising the Definition of Income Under Section 643(b)

Dear Sir or Madam:

I am the Chair of the Committee on Estate and Gift Taxation of The Association of the Bar of the City of New York (the "Committee"). This submission constitutes a partial response of the Committee to your request for public comments concerning proposed regulations revising the definition of income under Section 643(b) of the Internal Revenue Code of 1986, as amended (the "Code"), published at 66 F.R. 10396-10402.

Although the period for comment on the proposed regulations ended some time ago, the Committee is concerned that there is one issue not addressed in the proposed regulations which may undercut the effectiveness of the regulations as a whole. The concern was raised by the recent release of PLR 200231011 (May 6, 2002). The Committee apologizes for this late submission but hopes that the issue raised herein will be addressed by the final regulations.

Definition of Income - Proposed Regulation §1.643(b)-1

The definition of income should be modified to clarify that (i) the conversion of a traditional income-only interest to a unitrust interest which is a reasonable apportionment of the total return of the trust between income and remainder beneficiaries and (ii) the conversion of a unitrust interest to a traditional income-only interest will not be considered to shift any beneficial interest in the

trust and will not be considered to be an exchange of materially different property interests in the trust, if the state statute authorizing unitrust administration otherwise meets all of the requirements of this section.

Proposed Reg. §1.643(b)-1 provides that trust provisions that “depart fundamentally” from traditional principles of income and principal, that is, allocating ordinary income to income and capital gain to principal, generally will not be recognized. However, “amounts allocated between income and principal pursuant to applicable 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 income, capital gains, and appreciation.” The proposed regulations add that a state law that provides for the income beneficiary to receive each year a unitrust amount of between 3% and 5% of the annual fair market of the trust assets is a reasonable apportionment of the total return of the trust.

The recent PLR 200231011, however, raises the concern that the *conversion* of an existing income interest in a trust to a statutory unitrust interest might be considered an exchange of materially different property interests that would result in the realization of a gain or loss under IRC § 1001. In the relevant portion of this PLR, the parties entered into an agreement to resolve a dispute regarding the continued administration of a trust. Prior to this agreement, the taxpayer had a guaranteed minimum income interest in the trust subject to a floor and a ceiling and had no right to distributions of any additional principal. At the taxpayer’s death, the remainder would pass to specified charities. Under the agreement, the trust was to be restructured to provide that the charities would receive current distributions of principal in the same proportions as their interests in the remainder of the trust. The balance of the trust would continue for the benefit of the taxpayer. The taxpayer would be entitled to annual payments of 7% of the fair market value of the trust property, with the trustee having discretion to make additional distributions of income and principal to provide for the taxpayer’s reasonable support. At the taxpayer’s death, the remainder of the trust would be distributed in accordance with the taxpayer’s exercise of his general power of appointment, or, if not exercised, to his issue. The letter ruling concluded that under the agreement the taxpayer’s interest in the trust was being exchanged in a taxable transaction pursuant to Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991). The letter ruling noted that under Cottage Savings, property interests are “materially different” if the property interests embody “legal entitlements” that are “different in kind or extent” and found that the taxpayer’s interest in the modified trust would entail legal entitlements different from those he had prior to the agreement. As a result of this exchange, the taxpayer would be treated as recognizing gain on his interest in the trust.

We believe that the conversion of a traditional income interest to a unitrust interest pursuant to a state statute and the corresponding conversion of a unitrust interest to a traditional income interest do not result in an exchange of “materially different property interests,” should not result in the application of the Cottage Savings doctrine and should not require the income beneficiary of the trust to realize gain on his or her interest in the trust. A state statutory

definition of income to include a unitrust interest merely reflects the adaptation of traditional income and principal rules to recent changes in the marketplace and modern portfolio theory. The unitrust election replaces the trustee's traditional decisions regarding the allocation of trust assets between income producing and growth investments and permits the trustee to implement a total return investment strategy without harming the beneficial interests of the income beneficiary or remainderman. Just as the trustee's traditional decisions to allocate assets between income producing and growth investments are not considered a shifting of beneficial interests in the trust or the exchange of materially different property interests, so the election exercised under state law (or such a conversion is done in a manner consistent with state law) to pay the income beneficiary a unitrust amount which qualifies as a reasonable apportionment of the total return of the trust should not be treated as a shifting of beneficial interests or an exchange of materially different property interests. Needless to say, if the election to administer a trust as a unitrust does not shift beneficial interests in the trust or result in the exchange of materially different property interests, then the decision to convert a unitrust interest to a traditional income interest should obtain the same result. Moreover, any requirement under state law to obtain beneficiary consent to such an election serves as a release by the beneficiary to the trustees and should not change the result.

This position furthers the objective of the proposed changes in the definition of income as stated in the Preamble to the proposed regulations:

“Explanation of Provisions

“Definition of Income

“The proposed changes to the regulations will permit trustees to implement a total return investment strategy and to follow the applicable state statutes designed to treat the income and remainder beneficiaries impartially. ...”

Uncertainty concerning the income tax effect of conversion of a traditional income-only interest to a unitrust interest would be a deterrent to trustees implementing a total return investment strategy pursuant to applicable state statutes. Clarification that such a conversion does not shift beneficial interests in the trust or result in the exchange of materially different property interests is thus consistent with the stated purposes of the proposed regulations.

This position is also consistent with Prop. Reg. § 26.2601-(b)(4)(i)(d)(2) which provides that administration of a trust as a unitrust pursuant to state law will not be considered to shift a beneficial interest in the trust for generation-skipping transfer tax purposes if the state statute provides for a reasonable apportionment of the total return of the trust between the income and remainder beneficiaries. Moreover, the stated purpose of the proposed regulations quoted above,

“to permit trustees to implement a total return strategy to ensure that the income and remainder beneficiaries are treated impartially,” would be defeated if a trustee’s election to convert a traditional income interest to a unitrust interest resulted in a realization event of the entire unitrust interest. Under these circumstances, the trustee’s decision of whether to make the unitrust election would be driven by federal income tax consequences, not the trustee’s best judgment of how to treat the beneficiaries impartially.

We suggest including the following language (indicated below in italics) after the last sentence of § 1.643(b)-1:

In addition, the elections pursuant to the provisions of applicable state law to administer a trust as a unitrust and to administer a unitrust as a traditional income trust will not be considered to shift any beneficial interest in the trust, will not be considered to be an exchange of materially different property interests and will not constitute a realization event under §1001 if the state statute provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of this section.

These comments were prepared by The Committee on Estate and Gift Taxation of The Association of the Bar of the City of New York.

We appreciate the opportunity to submit these written comments and would welcome the opportunity to offer any additional assistance that might be desired.

Sincerely,

Barbara A. Sloan

BAS/kg

cc: Catherine Veihmeyer Hughes, Attorney-Advisor,
Office of Tax Legislative Counsel, Office of Tax Policy, Department of the Treasury