Internal Revenue Service

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Department of the Treasury

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Re: November 15, 1999
EIN-

Legend:
Grandparent 1 =
Grandparent 2 =
Grandparent 1's will =
Daughter =
Trust A =
Date 1 =
Date 2 =
Trustee =
Corporation =
Charity =

This is in response to your letter dated February 26, 1999, in which you requested rulings regarding the federal estate and gift tax consequences of a partial release of a limited power of appointment and the application of the generation-skipping transfer (GST) tax provisions of Chapter 13 of the Internal Revenue Code.

According to your submission, Grandparent 1 died testate on Date 1. Pursuant to the terms of his will, Grandparent 1 created four separate residuary trusts of equal value for the benefit of his four children, including Trust A for the benefit of Daughter and her descendants.

Article 5, Section c(1) provides, generally, that the Trustee shall pay to each child for whom a trust is named (or the descendants from time to time living of any deceased child) the net income of the trust estate as the Trustee in its discretion deems to be necessary for the needs and best interests of such child, or descendants of a deceased child, in that order and as a group, taking into consideration all income available to each of them for such purposes from all other sources known to the Trustee, and any other circumstances and factors which the Trustee deems pertinent. Any net income not so distributed by the Trustee during any calendar year shall be accumulated and added to the principal of the respective trust estate.

Article 5, Section c(2) provides that the Trustee is

authorized to pay to each child such sums from the principal of the trust estate of such child as the Trustee deems necessary or advisable from time to time for the best interests of the child and for the medical care, education, best interests, and welfare of any person dependent upon such child, taking into consideration all other income available to such child for such purposes from all sources known to the Trustee.

Article 5, Section c(3) provides that after the death of both Grandparent 1 and Grandparent 2, each child has the right at any time and from time to time during his or her lifetime by instrument in writing delivered to the Trustee to appoint any part or all of the corpus of his or her trust estate to or in trust for any one or more of his or her descendants from time to time living and such so-called charitable institutions existing under the laws of the state of which he or she is a resident which are exempt from state inheritance and estate taxes and Federal estate taxes, as he or she directs.

Article 5, Section c(4) states that upon the death of a child, the trust estate of such child as then constituted shall be held in trust for the benefit of, or distributed to or in trust for the benefit of, any one or more of such child's descendants, in such amount and in such manner and upon such terms and conditions as such child shall appoint by his or her last will, specifically referring to the power of appointment conferred upon him or her. However, each child may appoint any part or all of the income from his or her share to his or her surviving spouse until the death or remarriage of such spouse or for such shorter period as the child may designate.

Pursuant to Article 5, Section c(5), in default of the exercise of the power of appointment by a child, upon the death of such child, the trust estate of such child, or the part not effectively appointed, shall be distributed per stirpes to the child's then living descendants, if any. If there are no such descendants, the trust estate, or the part not effectively appointed, shall be distributed per stirpes to Grandparent 1's then living descendants, subject to certain withholding provisions. Each portion otherwise distributable to a descendant of Grandparent 1 for whom a trust estate or share of a trust estate is then being held is to be added to such trust estate or share.

Under Article 5, Section c(7), if at any time prior to the complete vesting or distribution of the trust, no child of Grandparent 1 nor any other descendant of Grandparent 1 shall be living, the entire remaining trust estate then in the hands of the Trustee shall be paid, transferred, and delivered to Charity.

Article 5, Section (d) provides that nothwithstanding any other provision of Trust 1, the trusts created pursuant to the terms of Trust 1 will terminate not later than twenty-one years after the death of the last survivor of Grandparent 1 and all beneficiaries under the will living at the date of Grandparent 1's death. The Trustee is directed to distribute any property then held in a trust to the persons entitled to receive the income therefrom, in the same shares or portions in which such income is then being paid to them.

On Date 2, Daughter irrevocably disclaimed any right granted to her pursuant to Article 5, Section c(3) of Grandparent 1's will to appoint during her lifetime any part or all of the corpus of Trust A to any charitable institution or institutions. Daughter reserves only the right to appoint during her lifetime any part or all of the corpus of Trust A among her descendants from time to time living, either outright or in trust, provided that any such trust is only for the benefit of one or more of her descendants.

The primary asset of Trust A is stock in Corporation, a C corporation. The Corporation's Board of Directors proposes to elect to treat Corporation as a small business corporation (an "S corporation"). Trustee proposes to consent to the S election. In order to convert Corporation to an S corporation, each of its shareholders must be eligible to hold S corporation stock as of the first day of the year for which the election is to take effect. Trustee proposes to make an election under § 1361(e)(3) to treat Trust A as an electing small business trust so that it will qualify as an eligible S corporation shareholder.

In an effort to ensure the continuing qualification of Corporation as an S corporation, Trustee intends to enter into a shareholder agreement with Corporation and Corporation's other shareholders to protect the S election.

Under the Section 3(a) of the proposed shareholder agreement, no shareholder may transfer, and no person may acquire, the legal or beneficial ownership of any share if such transfer or acquisition would cause the S status of the Corporation to terminate. Specifically, no transfer may be made to any person that is not eligible to be a shareholder of an S corporation under the applicable provisions of the Code as in effect at the time of the purported transfer. In addition, no shareholder may affirmatively transfer shares to a person if the transfer would cause the Corporation to exceed the maximum number of persons who are allowable S corporation shareholders.

Section 3(b) of the proposed shareholder agreement provides that no shareholder shall make any transfer of shares to any trust having multiple beneficiaries or amend any trust that owns

shares to increase the number of beneficiaries unless all such beneficiaries are persons eligible to be transferees pursuant to Section 3(a) and immediately after such transfer or amendment, the number of shareholders the Corporation is deemed to have for purposes of § 1361 would not exceed the maximum number of persons who are allowable S corporation shareholders pursuant to that section.

Notwithstanding any other provision of the shareholder agreement, the shareholders and the Corporation acknowledge and agree in Section 3(c) that none of the following shall be prohibited by the terms of the shareholder agreement: (i) the addition of a trust beneficiary due to the birth of an additional descendant of Grandparent 1; (ii) the exercise of a power of appointment granted to a beneficiary pursuant to the terms of any irrevocable trust that is in existence on the date of the agreement and that owns shares; (iii) the transfer of shares to any person in whose favor a power of appointment described in (ii) above is exercised; or (iv) the distribution of shares to (A) a beneficiary of any irrevocable trust that is in existence on the date of the agreement and that owns shares, pursuant to the terms thereof or (B) to the beneficiary of any trust created pursuant to the exercise of a power of appointment described in (ii) above, even if such addition, exercise, or distribution shall cause the termination of the Corporation’s S election.

Section 3(d) provides that prior to any transfer or other disposition of shares, if the Corporation in its discretion so requires, an opinion of counsel to the Corporation must first be received by the Corporation (the cost of which shall be borne by the shareholder whose shares are to be transferred or disposed of) that the transferee is (i) eligible to be a shareholder of an S corporation in accordance with the applicable requirements of the Code or (ii) that the transfer otherwise is allowable pursuant to the provisions of the shareholder agreement.

In addition to the other requirements of Section 3 of the shareholder agreement, Section 3(g) provides that no transfer of shares (including, without limitation, transfers pursuant to Section 3(c)) shall be permitted, and no purported transfer shall be effective, until a permitted transferee has executed a Supplemental Signature Page to the shareholder agreement. All parties agree that upon execution and acceptance of a Supplemental Signature Page, the shareholder agreement shall be amended and the transferee shall have the rights and obligations of a shareholder under the agreement.

Section 3(h) of the shareholder agreement provides that shareholders possessing 66 2/3% of the total voting power of all outstanding shares may at any time and from time to time agree in writing to authorize or ratify any transfer of shares which would

otherwise not be permitted by the shareholder agreement, in which event the transfer shall be deemed for all purposes to comply with the shareholder agreement notwithstanding any other provision of the agreement.

Under Section 3(i), if a transfer of shares is required to be made pursuant to Section 3(c)(ii), (iii), or (iv) to a transferee who is not already a shareholder and who has not previously executed, or currently refuses to execute, a Supplemental Signature Page to the shareholder agreement (a non-consenting transferee), certain procedures will apply. The shareholders may allow the transfer of shares to the non-consenting transferee pursuant to the procedure set forth in Section 3(h). Otherwise, the shares that otherwise would be transferred to the non-consenting transferee shall instead be redeemed by the Corporation for a price equal to the fair market value of the shares as of the valuation date.

Pursuant to Section 5 of the proposed shareholder agreement, any purported transfer in violation of the shareholder agreement shall not affect the beneficial or legal ownership of shares.

Section 6 of the agreement states that subject to any limitations on dividends or other distributions imposed by statute, the Corporation shall make pro rata dividend distributions of money, based on ownership of shares, to pay the Federal, state, and local income tax on the income and gain of the Corporation (net of any tax benefits produced for the shareholders by the Corporation's losses, deductions, and credits for the current year and for each prior year during which the Corporation's S election was in effect) that passes through to the shareholders under the applicable provisions of the Code in respect of each taxable year (or portion thereof) of the Corporation for which its S election is in effect.

Section 7 of the proposed shareholder agreement provides that the Corporation shall (a) not issue more than one class of shares, (b) use its best efforts to avoid a termination of its S election, and (c) in the event of a termination of the S election, use its best efforts to distribute to each shareholder such shareholder's net share of the Corporation's undistributed taxable income for all taxable years for which the S election was in effect, to the extent permitted by law and consistent with the obligations of the Corporation to creditors, agreements to which the Corporation is a party, and other business considerations, within the period when such a distribution will be considered a non-dividend distribution under § 1371(e)(1).

Section 9 of the proposed shareholder agreement states that if the Corporation's status as an S corporation is terminated inadvertently and the Corporation wishes to obtain a ruling under

§ 1362(f), each shareholder agrees to make any adjustments required pursuant to § 1362(f)(4) and approved by the Corporation's Board of Directors. A shareholder's obligation to make such adjustments shall continue after the shareholder has ceased to own shares in the Corporation and after the shareholder agreement has terminated.

Except as directed by the shareholder agreement, the existing Trustee will continue to serve in the same manner as it previously served. In addition, Trust A will continue to be administered in accordance with the terms and conditions set forth in Trust 1.

Taxpayer requests the following rulings:

1) Daughter's irrevocable disclaimer of her lifetime power to appoint any part or all of the corpus of Trust A to or in trust for charitable institutions will not be a taxable transfer for federal gift tax purposes.

2) Daughter's irrevocable disclaimer of her lifetime power to appoint any part or all of the corpus of Trust A to or in trust for charitable institutions will not cause any part of Trust A to be included in Daughter's gross estate under § 2041.

3) The exempt status of Trust A for GST tax purposes will not be affected by the following: (i) the Trustee's consent to Corporation's S election on behalf of Trust A; (ii) the Trustee's execution of an "electing small business trust" election on behalf of Trust A; (iii) the Trustee's execution of the shareholder agreement on behalf of Trust A; and (iv) Daughter's irrevocable disclaimer of her lifetime power to appoint any part or all of the corpus of Trust A to or in trust for charitable institutions.

Rulings No. 1 and 2:

Section 2041(a)(2) provides that the value of the gross estate includes the value of all property to the extent of any property with respect to which the decedent has at the time of his 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 which is of such nature that if it were a transfer of property owned by the decedent, the property would be includible in the decedent's gross estate under §§ 2035 to 2038, inclusive.

Section 2041(a)(3) provides that the value of the gross estate includes the value of all property to the extent of any property with respect to which the decedent- (A) by will, or (B) by a disposition which 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, 2036, or 2037, exercises a power of appointment created after October 21, 1942, by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power.

Section 20.2041-1(c)(1) of the Estate Tax Regulations defines the term "general power of appointment" as any power of appointment exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate. A power of appointment is not a general power if by its terms it is either –

(a) Exercisable only in favor of one or more designated persons or classes other than the decedent or his creditors, or the decedent's estate, or the creditors of his estate, or

(b) Expressly not exercisable in favor of the decedent or his creditors, or the decedent's estate or the creditors of his estate.

Section 20.2041-3(a)(2) provides that if the power is a general power of appointment, the value of an interest in property subject to the power is includible in the decedent's gross estate under section 2041(a)(2) if either --

(i) The decedent has the power at the time of his death (and the interest exists at the time of his death), or

(ii) The decedent exercised or released the power, or the power lapsed, under the circumstances and to the extent described in § 20.2041-3(d).

Section 20.2041-3(a)(3) provides that if a power is not a general power of appointment, the value of the property subject to the power is includible in the holder's gross estate under § 2041(a)(3) only if it is exercised to create a further power under certain circumstances described in § 20.2041-3(e).

Section 20.2041-3(e)(1) provides that property subject to a power of appointment created after October 21, 1942, which is not a general power, is includible in the gross estate of the holder of the power under § 2041(a)(3) if the power is exercised, and if both of the following conditions are met:

(i) If the exercise is (a) by will, or (b) by a disposition which is of such nature that if it were a transfer of property

owned by the decedent, the property would be includible in the decedent's gross estate under §§ 2035 through 2037; and

(ii) If the power is exercised by creating another power of appointment which, under the terms of the instruments creating and exercising the first power and under applicable local law, can be validly exercised so as to (a) postpone the vesting of any estate or interest in the property for a period ascertainable without regard to the date of the creation of the first power, or (b) (if the applicable rule against perpetuities is stated in terms of suspension of ownership or of the power of alienation, rather than of vesting) suspend the absolute ownership or the power of alienation of the property for a period ascertainable without regard to the date of the creation of the first power.

Under § 2514(b), 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.

In general, rules similar to those contained in § 2041 and the underlying regulations regarding the estate tax consequences of the release, lapse, or exercise of a power of appointment apply for purposes of § 2514, regarding the gift tax consequences of the lifetime release, lapse, or exercise of a power of appointment.

Section 25.2514-1(a)(1) provides that the exercise or complete release of a general power of appointment created after October 21, 1942, and under certain circumstances the exercise of a power of appointment (not a general power of appointment) created after October 21, 1942, by the creation of another power of appointment, will be treated as transfers of property.

Section 2514(d) and § 25.2514-3(a) provide that the exercise of a power of appointment that is not a general power of appointment is considered to be a transfer if it is exercised under certain circumstances, as described in § 25.2514-3(d), to create a further power.

Section 25.2514-3(d) provides that there is a transfer for purposes of the gift tax of the value of property (or of property rights or interests) with respect to which a power of appointment, which is not a general power of appointment, created after October 21, 1942, is exercised by creating another power of appointment, which under the terms of the instruments creating and exercising the first power and under applicable local law, can be validly exercised so as to (1) postpone the vesting of any estate or interest in the property for a period ascertainable without regard to the date of the creation of the first power, or (2) (if the applicable rule against perpetuities is stated in terms of suspension of ownership or of the power of alienation,

rather than of vesting) suspend the absolute ownership or the power of alienation of the property for a period ascertainable without regard to the date of the creation of the first power.

Based on the information submitted and the representations made, we conclude that: (1) Daughter's irrevocable disclaimer/release of her lifetime power to appoint any part or all of the corpus of Trust A to or in trust for charitable institutions will not be a release of a general power of appointment and will, therefore, not be a taxable transfer for federal gift tax purposes; and (2) Daughter's irrevocable disclaimer/release of her lifetime power to appoint any part or all of the corpus of Trust A to or in trust for charitable institutions will not cause any part of Trust A to be included in Daughter's gross estate under § 2041.

Ruling No. 3:

Section 2601 imposes a tax on every generation-skipping transfer. Section 26.2601-1(a)(1) of the Generation-Skipping Transfer Tax Regulations provides that the GST tax applies to any generation-skipping transfer made after October 22, 1986. Section 26.2601-1(b)(1) provides an exception to this rule for any distributions from a trust that was irrevocable on September 25, 1985. However, this exception does not apply to a pro rata portion of any generation-skipping transfer under an irrevocable trust where additions were made to the trust after September 25, 1985.

In addition, a modification to a trust that results in a change in the quality, value, or timing of any beneficial interest provided for under the trust instrument will cause the trust to lose its exempt status.

Section 26.2601-1(b)(1)(v)(A) provides that, except as provided under § 26.2601-1(b)(1)(v)(B), where any portion of a trust remains in the trust after the post-September 25, 1985, release, exercise, or lapse of a power of appointment over that portion of the trust, and the release, exercise, or lapse is treated to any extent as a taxable transfer under chapter 11 or chapter 12, the value of the entire portion of the trust subject to the power that was released, exercised, or lapsed is treated as if that portion had been withdrawn and immediately retransferred to the trust at the time of the release, exercise, or lapse.

Section 26.2601-1(b)(1)(v)(B) provides a special rule for certain powers of appointment. This section provides that the release, exercise, or lapse of a power of appointment (other than a general power of appointment as defined in § 2041(b)) will not be treated as an addition to a trust if- (1) such power of

appointment was created in an irrevocable trust that is not subject to Chapter 13 under § 26.2601-1(b)(1); and (2) in the case of an exercise, such power of appointment is not exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date of creation of the trust, extending beyond any life in being at the date of creation of the trust plus a period of 21 years.

In the present case, it has been represented that Trust A was irrevocable on September 25, 1985, and that there have been no additions, constructive or otherwise, to Trust A after that date. Based on the representations made and the facts submitted, we conclude that Daughter's irrevocable disclaimer/release of her lifetime power to appoint any part or all of the corpus of Trust A to or in trust for charitable institutions will not be treated as a constructive addition to Trust A.

In addition, we conclude that there is no change in the quality, value, or timing of any beneficial interest in Trust A resulting from the following: (i) the Trustee's consent to Corporation's proposed S election; (ii) the Trustee's election to treat Trust A as an electing small business trust; and (iii) the Trustee's execution of the proposed shareholder agreement. Further, Daughter's irrevocable disclaimer/release of her lifetime power to appoint any part or all of the corpus of Trust A to or in trust for charitable institutions is not a modification to Trust A that results in a change in the quality, value, or timing of any beneficial interest provided for under the terms of Trust A. Therefore, neither Daughter's disclaimer/release, nor items (i)-(iii) above, will cause Trust A to lose exempt status for GST tax purposes. Provided that there are no additions, constructive or otherwise, to Trust A after September 25, 1985, distributions from Trust A to skip persons will not be subject to the GST tax.

Except as specifically ruled herein, we express no opinion as to the consequences of this transaction under the cited provisions of the Code or under any other provisions of the Code. Specifically, we express no opinion on whether Trust A will qualify as an electing small business trust within the meaning of § 1361(e).

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,
Assistant Chief Counsel
(Passthroughs and Special Industries)
By George Masnik, Chief, Branch 4

Enclosure