

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Refer Reply To:
CC:PSI:4 - PLR-102321-02
Date: DECEMBER 09, 2002

Re:

Legend:

Date 1 =
Husband =
Wife =
Irrevocable Trust =

Child 1 =

Child 2 =

Child 3 =

Child 4 =

Date 2 =
Date 3 =
State Law =
Exempt Trust =

Non-Exempt Trust =

X =
Court =

Dear _____ :

This is in response to a letter dated December 26, 2001, and subsequent correspondence, requesting rulings regarding the generation-skipping transfer tax (GSTT) consequences of a proposed judicial modification of a trust.

Facts

The facts submitted and representations made are as follows. On Date 1, prior to September 25, 1985, Husband and Wife (Settlors) created an irrevocable trust (Irrevocable Trust), for the benefit of Settlor's children, Child 1, Child 2, Child 3, and Child 4, the "Income Beneficiaries" and Settlor's grandchildren, the "Corpus Beneficiaries."

Under the terms of Irrevocable Trust, 20 percent of the net income of Irrevocable Trust must be retained and accumulated as part of corpus. The remaining 80 percent of the total net income of Irrevocable Trust must be distributed at least annually in equal shares among the four Income Beneficiaries. Upon the death of each of the first three Income Beneficiaries to die and until the death of the last surviving Income Beneficiary, the deceased Income Beneficiary's share of Irrevocable Trust income will be distributed to that beneficiary's then living descendants, per stirpes. However, if such deceased Income Beneficiary has no surviving descendants or if all of the surviving descendants die before the last surviving Income Beneficiary, then the deceased Income Beneficiary's share of Irrevocable Trust income will be distributed "one share to each of the Corpus Beneficiaries, then living, share and share alike, per capita, and one share to the descendants of each deceased Corpus Beneficiary, per stirpes." If there are no Corpus Beneficiaries or descendants of deceased Corpus Beneficiaries then living, the deceased Income Beneficiary's share of Irrevocable Trust income will be distributed among the remaining Income Beneficiaries, share and share alike.

Upon the death of the last surviving Income Beneficiary, the entire 80 percent of Irrevocable Trust income will be distributed "one share to each of the Corpus Beneficiaries, then living, share and share alike, per capita, and one share to the descendants of each deceased Corpus Beneficiary, per stirpes." If any Corpus Beneficiary dies without surviving descendants or if all of a deceased Corpus Beneficiary's descendants die before Irrevocable Trust terminates, the deceased beneficiary's share of Irrevocable Trust income will be distributed "one share to each of the remaining Corpus Beneficiaries, then living, share and share alike, per capita, and one share to the descendants of each deceased Corpus Beneficiary, per stirpes." Any part of the Irrevocable Trust income not so distributed will be added to the corpus of Irrevocable Trust.

Irrevocable Trust and all of the trusts created under it will terminate 21 years after the death of the last survivor of the four Income Beneficiaries. Upon the termination of Irrevocable Trust, all of the assets of Irrevocable Trust will be distributed

"one share to each of the Corpus Beneficiaries then living, share and share alike, per capita, and one share to the descendants of each deceased Corpus Beneficiary, per stirpes." If a deceased Corpus Beneficiary has no descendants, the Corpus Beneficiary's share will be distributed one share to each of the other Corpus Beneficiary's then living and one share, per stirpes, among the descendants of a deceased Corpus Beneficiary who had descendants.

On Date 2, Husband died. Under Husband's will, his residuary estate passed to Irrevocable Trust. As of Husband's date of death, Irrevocable Trust was severed under State Law on a fractional basis into Exempt Trust, the subject of this ruling request, and Non-Exempt Trust. Under the fractional formula used to sever Irrevocable Trust, at Husband's date of death, Exempt Trust consisted of that portion of the residuary estate under Husband's will equal in value to \$x (Husband's chapter 13 portion) and all of the assets of Irrevocable Trust immediately before his death (non-chapter 13 portion). On the Schedule R of Husband's Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, Husband's \$1 million GST exemption was allocated to the chapter 13 portion of Exempt Trust in an amount sufficient to provide a zero inclusion ratio.

On Date 3, Wife transferred property (Wife's chapter 13 portion) to Exempt Trust and allocated her remaining GST exemption to this chapter 13 portion of Exempt Trust in an amount sufficient to provide a zero inclusion ratio.

Upon their creation at Husband's death, the terms of Exempt Trust and Non-Exempt Trust were identical to those of Irrevocable Trust, and the trustees of Irrevocable Trust continued to serve as the trustees of each separate trust.

It is represented that Husband's and Wife's chapter 13 portions of Exempt Trust currently have a generation-skipping transfer (GST) tax inclusion ratio of zero.

Child 1, Child 2, Child 3, and Child 4 are currently serving as co-trustees of Exempt Trust.

The trustees and Wife, as settlor of Irrevocable Trust, now propose to submit an Application for Modification of Trusts to Court seeking a judicial modification of Exempt Trust in response to changed circumstances, *i.e.*, the necessity of limited powers of appointment to prevent the family dissension that would occur if an Income Beneficiary dies without descendants. It is represented that two of Settlor's children currently have no descendants and are not likely to have descendants and that this circumstance was not anticipated by Settlor.

The application requests a modification of Exempt Trust to include the following provision granting each Income Beneficiary a testamentary limited power of appointment over the beneficiary's share of net income of Exempt Trust under the circumstances specified:

Each Income Beneficiary that either (i) dies leaving no descendants, or (ii) dies leaving descendants, all of whom die before the death of the last to survive of the four Income Beneficiaries, shall have a testamentary limited power of appointment over the [share] of the net income of the trust that his or her descendants would have been entitled to receive if living at the time of the relevant distribution of net income to the other Income Beneficiary(s). This testamentary limited power of appointment may only be exercised by specific reference in the duly probated Will of the Income Beneficiary, and may be exercised in favor of any person or entity other than himself or herself, his or her creditors, his or her estate, and the creditors of his or her estate; provided that, the power may not be exercised in favor of any beneficiary in which the exercise would result in shifting a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in Section 2651 of the Internal Revenue Code) than the person or persons who hold the beneficial interest in the absence of the exercise of the testamentary limited power of appointment. To the extent that an Income Beneficiary exercises his or her limited power of appointment over all or any portion of his or her [share] of the net income of the Trust Estate, such appointed income shall be paid to the person(s) and/or entity(s) entitled to receive such income by virtue of the exercise of the limited power of appointment by the Income Beneficiary.

The unappointed share of each deceased Income Beneficiary among the first three to die will be distributed under the current provisions governing distributions of such beneficiaries' shares before the death of the fourth Income Beneficiary to die.

There are currently six Corpus Beneficiaries.

The trustees have requested the following rulings:

1. The proposed judicial modification of Exempt Trust will 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 hold the beneficial interest prior to the modification and will not extend the time for vesting of any beneficial interest in the trust beyond the period provided under the original terms of the trust.

2. The proposed judicial modification of Exempt Trust will not cause the trust to lose its GST exempt status or otherwise to become subject to the provisions of chapter 13.

Law and Analysis

Section 2601 of the Internal Revenue Code imposes a tax on each generation-skipping transfer which includes under § 2611(a) a taxable distribution, a taxable termination, and a direct skip.

Under § 1433(a) of the Tax Reform Act of 1986 (Act), the generation-skipping transfer tax is generally applicable to generation-skipping transfers made after October 22, 1986.

Under § 2602, the amount of tax imposed under § 2601 is determined by multiplying the taxable amount by the applicable rate. The taxable amount of a taxable distribution is the amount received by the transferee (§ 2621), of a taxable termination is the amount of property with respect to which there was a termination (§ 2622), and of a direct skip is the amount received by the transferee (§ 2623).

Under § 2641, the term “applicable rate” means the product of the maximum federal estate tax rate in the year that the generation-skipping transfer occurs and the inclusion ratio.

Under § 2642(a)(1), the inclusion ratio with respect to any property transferred in a generation-skipping transfer is 1 minus the applicable fraction. Under § 2642(a)(2), in general, the numerator of the applicable fraction is the GST exemption amount allocated to the property transferred; and the denominator is the value of the property transferred.

Under § 2631, every individual is allowed a GST exemption amount which may be allocated by the individual or the individual’s executor to any property with respect to which the individual is the transferor.

Under § 1433(b)(2)(A) of the 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)(1)(iv)(A) provides that, if an addition is made after September 25, 1985, to an irrevocable trust which is excluded from chapter 13 by reason of § 26.2601-1(b)(1), a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the provisions of chapter 13. If an addition is made, the trust is thereafter deemed to consist of two portions, a portion not subject to chapter 13 (the non-chapter 13 portion) and a portion subject to chapter 13 (the chapter 13 portion), each with a separate inclusion ratio (as

defined in § 2642(a)). The non-chapter 13 portion represents the value of the assets of the trust as it existed on September 25, 1985. The applicable fraction for the non-chapter 13 portion is deemed to be 1, and the inclusion ratio for such portion is zero. The chapter 13 portion represents the value of all additions made to the trust after September 25, 1985. The inclusion ratio for the chapter 13 portion is determined under § 2642. Separate portions of one trust are so required only for purposes of determining inclusion ratios.

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.

Section 26.2601-1(b)(4)(i)(D) provides that a modification 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 for in the original trust. 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.

In the present case, Exempt Trust consists of a non-chapter 13 portion (assets from Irrevocable Trust), Husband's chapter 13 portion (assets from his residuary estate), and Wife's chapter 13 portion (property transferred by Wife on Date 3). It is represented that Husband's and Wife's chapter 13 portions of Exempt Trust currently have a generation-skipping transfer (GST) tax inclusion ratio of zero.

The non-chapter 13 portion of Exempt Trust is subject to the rules under § 26.2601-1(b)(4)(i). With regard to the chapter 13 portions of Exempt Trust, no guidance has been issued concerning changes 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 change that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of such a trust.

The proposed judicial modification will grant each Income Beneficiary a testamentary limited power of appointment over only that share of the income of Exempt Trust that the Income Beneficiary's descendants would have been entitled to receive if living at the time of the relevant income distribution to the other Income Beneficiaries. Further, despite the proposed judicial modification, Exempt Trust must terminate in all events 21 years after the death of the last survivor of the four Income Beneficiaries who were all living at the date of the creation of the trust.

Accordingly, based on the facts submitted and the representations made, we rule that the proposed judicial modification of Exempt Trust will not result in a shift of any beneficial interest in the trust to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the proposed judicial modification. Further, the proposed judicial modification of Exempt Trust will not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Finally, the proposed judicial modification of Exempt Trust will not cause the trust to lose its GST exempt status or otherwise to become subject to the provisions of chapter 13.

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. Specifically, we express no opinion on the federal gift tax consequences.

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 yours,

Lorraine E. Gardner
Senior Counsel, Branch 4
Office of Associate Chief Counsel
(Passthroughs and Special
Industries)

Enclosure

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