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Citation 1 -
Citation 2 -

Dear :

This is in response to your May 29, 2003, letter and other correspondence requesting rulings concerning the generation-skipping transfer tax, estate tax, gift tax, and income tax consequences of the proposed modification of Trust.

The facts submitted are as follows:

On Date 1, prior to September 25, 1985, Trustor created Trust, an irrevocable trust. Trustor and two of his children, Child A, Child B, were designated as trustees. At the time Trust was executed, Trustor was married to Spouse and had 3 children, Child A, Child B, and Child C, and 5 grandchildren. Trust is governed by the laws of State S.

The dispositive terms of Trust provide that the trustees will distribute 15 percent of the trust net income each year to "such charitable, educational, religious, and other institutions as may, from time to time, be recognized by the Commissioner of Internal Revenue as deductible gifts for income tax." The trust provides for monthly payments from net income of specific amounts to named individuals during their respective lives. The remaining net income is to be divided into shares and accumulated in the trustee's discretion or distributed to Spouse, Child A, Child B and Child C. Upon Spouse's death, her share will be divided among the living children and, upon each child's death, that child's share will be paid in equal shares to that child's children, and, upon the death of that grandchild, that share will be divided into equal shares and paid to the grandchild's issue. In the event there are no issue to whom the share will be paid, that share will be paid in equal shares to the deceased beneficiary's siblings and the sibling's issue. In the event that all lineal descendants of any of Trustor's children die before the termination of Trust, that share will be paid to Trustor's other children and their lineal descendants.

Trust also provides that, in the event a minor is entitled to income, the trustee is authorized to make distributions from income for the minor's care, education, maintenance, welfare, travel or other benefit in the beneficiary's interest. Any excess is to be accumulated for the benefit of the minor and distributed to him/her upon reaching the age of majority. In addition, the trustee is to distribute \$5,000 from principal to specified grandchildren upon each reaching age 25.

Trust is to terminate upon the earlier of 21 years after the death of the last to die of Trustor's children and grandchildren living on Date 1, or the death of all of Trustor's lineal descendants. Upon termination, \$A is to be distributed to X University Foundation, or, if it is not then in existence, to X University. The remaining principal is

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to be divided into equal parts and distributed, by right of representation, among the lineal descendants then living of Child A, Child B, and Child C. If there are no living lineal descendants at that time, the principal is to be distributed to X University Foundation, or, if it is not then in existence, to X University.

By court order dated Date 2, Trust was construed to provide that any lawfully adopted adult or minor child are eligible to become beneficiaries of Trust and that adopted children shall, for purposes of Trust, enjoy equal status with natural born children.

Trust was construed by court order dated Date 3, to provide guidelines for trustee succession and service. Under the court's construction, an independent corporate trustee was selected to serve as a third trustee. Also, it was determined that each trustee would select its individual or corporate successor trustee, subject to approval of a majority of the current trustees and fifty percent of the then current income beneficiaries. In addition, the court determined that no more than one individual from any one of the three family lines may serve as trustee at one time.

Trustor, Spouse, and their children, Child A, Child B, and Child C, are no longer living. Currently, Descendants A - L are individual income beneficiaries of Trust. Each beneficiary is entitled to a percentage of the income that varies depending upon the particular beneficiary's degree of relationship to Child A, Child B, and Child C.

The twelve individual income beneficiaries have different needs and different investment philosophies. The trustees and beneficiaries propose to petition the appropriate local court to amend Trust in its entirety primarily to create trust shares for each current income beneficiary, incorporate the provisions of the previous court orders on Date 2 and Date 3, and revise the charitable dispositive provision.

Under the proposed modification of Trust, the trustees will divide the assets of Trust into twelve separate trust shares, one for each income beneficiary. Each share will be determined based on the specified percentage of the trust income that each beneficiary currently receives that is dependent upon that particular beneficiary's degree of relationship to the children of Trustor.

The trustee of each trust share will distribute annually to charitable organizations described in § 170(c) of the Internal Revenue Code, an amount equal to the greater of 15 percent of the net income of each trust share for that year or Y percentage of the net fair market value of the assets of each trust share determined as of the first day of that taxable year of Trust. The remaining net income of each beneficiary's trust share will be distributed by the trustee, at least quarterly, to that beneficiary. Upon the death of each beneficiary, if the beneficiary has surviving issue, that beneficiary's trust share will be allocated to separate trust shares, one for each surviving child and one for the issue of any deceased child, by right of representation. Each trust share will be held and

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administered for the benefit of the issue and subsequent issue consistent with the trust provisions described above. If the deceased beneficiary has no surviving issue, the beneficiary's trust share will be divided into separate trust shares, by right of representation, for the then-surviving issue of the deceased beneficiary's nearest ancestor who has issue then surviving and who is also an issue of Trustor. Otherwise, any assets will be divided, by right of representation, into separate trust shares for the then surviving issue of Trustor. Each separate trust share will be administered for the benefit of the issue consistent with the trust provisions described above. In the event that no issue of Trustor survives, the assets in the remaining trust share will be distributed to X University Foundation, or, if it is not then in existence, to X University. In the event that the net income of any trust share is to be distributed to any beneficiary who has not then attained the age of majority, the trustee may make discretionary distributions to provide for the health, education, support and maintenance of the beneficiary. Upon that beneficiary reaching the age of majority, any accumulated income will be distributed to that beneficiary.

As modified, the trustee of each trust share is authorized "[T]o credit or charge to income or principal, or to apportion between them, any receipts and any disbursements, and generally to determine all questions as between trust assets and to credit or charge to income or principal, or to apportion between them, any receipt or gain or any charge, disbursement, or loss in accordance with [Citation 1], as amended from time to time." Further, the trustee is authorized to manage trust assets in a manner that emphasizes "total return" and asset allocation principles consistent with the Uniform Prudent Investor Act.

Each trust share will terminate upon the earlier of 21 years after the death of the last survivor of the issue of Trustor alive on Date 1, or the death of all of Trustor's lineal descendants. This termination provision is consistent with the termination provision under the terms of the Trust as originally executed.

Upon termination, a total of \$A is to be distributed to X University Foundation, or, if it is not then in existence, to X University. A specified amount is to be distributed from each trust share created by the modification, or from any related subtrust share in proportion to the allocation of assets from a prior related subtrust or trust share. The remaining assets in each trust share will be distributed to the then current beneficiary or, if the beneficiary has not yet attained the age of majority, that share will be held in trust for the benefit of that beneficiary and distributed upon the beneficiary reaching the age of majority, or the beneficiary's estate if the beneficiary dies before attaining the age of majority.

As stated above, the Trust as modified will incorporate the provision from the court-ordered construction on Date 2 that included legally adopted children in the terms "child," "children," and "issue."

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The Trust as modified will also incorporate trustee succession provisions similar to the court-ordered modification on Date 3 of the trustee provisions. Under these provisions, Descendant F, Descendant K and a relative of Descendant A will serve as transition trustees for a period not to exceed two years. At the end of the transition period, the current primary income beneficiary of each trust share may designate either a corporate trustee with at least \$250,000,000 in managed trust assets to serve as a successor trustee, or one or more of the transition trustee(s) to serve as a successor trustee(s). If none is designated by the income beneficiary, the transition trustee(s) will serve as successor trustee(s). After the transition period, a majority of the income and remainder beneficiaries may remove a current trustee and a court will appoint a successor, which must be a corporate trustee with significant trust assets under management. Trustees are prohibited from engaging in any transaction, directly or indirectly, that constitutes an act of self-dealing, or creates a conflict of interest as prohibited by laws governing fiduciaries.

Rulings requested

- (1) The modification of Trust into separate trust shares, as proposed, will not result in Trust losing its status as exempt from generation-skipping transfer (GST) tax and distributions from the trust shares and termination of the trust shares will not be subject to the GST tax.
- (2) The modification of Trust into separate trust shares, as proposed, will not constitute a taxable sale or exchange under § 1001.
- (3) The distribution of the Trust assets to the separate trust shares, as proposed, will not result in a taxable gift under § 2501 by any party.
- (4) The power of the beneficiaries to designate successor trustees will not constitute the creation of or exercise of a power of appointment under § 2041 in or by any beneficiary.

Ruling Request #1: Generation-skipping Transfer Tax

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 § 1433(a) of the Tax Reform Act of 1986 (the Act), 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

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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) of the Generation-skipping Transfer Tax Regulations, 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.

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Section 26.2601-1(b)(4)(i)(E), Example 5, considers a situation where, in 1980, Grantor established an irrevocable trust for the benefit of his two children, A and B, and their issue. Under the terms of the trust, the trustee has the discretion to distribute income and principal to A, B, and their issue in such amounts as the trustee deems appropriate. On the death of the last to die of A and B, the trust principal is to be distributed to the living issue of A and B, per stirpes. In 2002, the appropriate local court approved the division of the trust into two equal trusts, one for the benefit of A and A's issue and one for the benefit of B and B's issue. The trust for A and A's issue provides that the trustee has the discretion to distribute trust income and principal to A and A's issue in such amounts as the trustee deems appropriate. On A's death, the trust principal is to be distributed equally to A's issue, per stirpes. If A dies with no living descendants, the principal will be added to the trust for B and B's issue. The trust for B and B's issue is identical (except for the beneficiaries), and terminates at B's death at which time the trust principal is to be distributed equally to B's issue, per stirpes. If B dies with no living descendants, principal will be added to the trust for A and A's issue. The division of the trust into two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the division. In addition, the division does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the two partitioned trusts resulting from the division will not be subject to the provisions of chapter 13.

Example 8, contained in § 26.2601-1(b)(4)(i)(E), considers a situation where the grantor established an irrevocable trust under the terms of which trust income is payable to A for life and, upon A's death, the remainder is to pass to A's issue, per stirpes. The court approves a modification to the trust that converts A's income interest into the right to receive the greater of the entire income of the trust or a fixed percentage of the trust assets valued annually to be paid each year to A for life. 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. In this example, the modification can only operate to increase the amount distributable to A and decrease the amount distributable to A's issue. In addition, 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. Therefore, the modification will not subject the trust to the provisions of chapter 13.

In the present case, Trust was irrevocable on September 25, 1985, and it is represented that no additions, actual or constructive, have been made to Trust after that date.

The proposed modification is substantially similar to the situation described in Example 5 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 proposed reformation. The separate trust shares will

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terminate at the same time as provided under the terms of Trust. Thus, the modification will not extend the time for vesting of any beneficial interest in the trust shares beyond the period provided for in Trust.

As in Example 8, the modification changing the method for determining the amount distributable to the charitable organizations can only operate to increase the amount distributable to those organizations and decrease the amount distributable to individual beneficiaries and their issue. In addition, this proposed modification will not extend the time for vesting of any beneficial interest beyond the period provided for in the trust instrument.

The modifications to the trust shares regarding the number of individual trustees, the identity of the corporate trustees, and the appointment of successor corporate trustees, are administrative in nature. The court order construing the terms “child,” “children,” and “issue” as used in the trust instrument is consistent with applicable local law and resolved a bona fide issue regarding the interpretation of the trust instrument.

Regarding the modification authorizing the trustees to allocate receipts and disbursements between income and principal, the law of State S provides, in pertinent part, at Citation 1:

(a) In allocating receipts and disbursements to or between principal and income, * * * a fiduciary:

* * *

(3) shall administer a trust or estate in accordance with the [Uniform Income and Principal Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration;

* * *

(b) In exercising the power to adjust under [Citation 2] * * *, a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries. A determination in accordance with the act is presumed to be fair and reasonable to all of the beneficiaries.

The law of State S further provides, in pertinent part, at Citation 2, that:

(a) A trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or

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must be distributed to the beneficiary by referring to the trust's income, and the trustee determines, after applying the rules of [Citation 1] and considering any power the trustee may have under the trust to invade principal or accumulate interest, that the trustee is unable to comply with [Citation 1].

Thus, consistent with § 26.2601-1(b)(4)(i)(D), under the proposed modification, the trust shares will be administered in conformance with applicable local law, which permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries and provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust. Thus, this modification will not be considered to shift the beneficial interest in the trust.

Accordingly, based on the facts submitted and the representations made and assuming the transaction is carried out as proposed and is effective under State law, we conclude that the modification of Trust, as proposed, will not cause Trust to lose its exempt status for generation-skipping transfer tax purposes of § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i) or cause Trust, the trust shares, or any distributions from Trust or the trust shares, to be subject to generation-skipping transfer taxes under § 2601. Accordingly, after the proposed modification, Trust and the trust shares will continue to be exempt from the GST tax imposed under § 2601 provided there are no additions to Trust after September 25, 1985.

Ruling Request #2: Income Tax

Section 61(a)(3) provides that gross income includes gains derived from dealings in property and, under § 61(a)(15), from an interest in a trust.

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 § 1011 for determining loss over the amount realized.

Section 1001(b) states 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 (other than money) received. Under § 1001(c), except as otherwise provided in subtitle A, the entire amount of 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

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other property differing materially either in kind or in extent, is treated as income or loss sustained.

A partition of jointly owned property is not a sale or other disposition of property where the co-owners of the joint property sever their joint interests but do not acquire a new or additional interest as a result of the transaction. Thus, neither gain nor loss is realized on a partition. See Rev. Rul. 56-437, 1956-2 C.B. 507.

In Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), a financial institution exchanged its interests in one group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans. The two groups of mortgages were considered "substantially identical" by the agency that regulated the financial institution. The issue presented was whether the transaction constituted a sale or exchange resulting in the realization of gain or loss under § 1001.

The Court concluded that § 1.1001-1 reasonably interprets § 1001(a) and stated that an exchange of property gives rise to a realization event under § 1001(a) if the properties exchanged are "materially different." In defining what constitutes a "material difference" for purposes of § 1001(a), the Court stated that properties are "different" in the sense that is "material" to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent. Id. at 564-65. The Court held that mortgage loans made to different obligors and secured by different homes did embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans. Id. at 566.

In the instant case, the Trust will be divided pro rata into trust shares only with the approval of the appropriate local court in State S. Except for the changes described above, all other provisions of Trust will remain unchanged. It is consistent with the Supreme Court's opinion in Cottage Savings to find that the interests of the beneficiaries of the individual trust shares will not differ materially from their interests in the original Trust. Accordingly, the proposed transaction will not result in a material difference in kind or extent of the legal entitlements enjoyed by the beneficiaries, and no gain or loss is recognized on the partition of the trust for purposes of § 1001(a).

Ruling Request #3: Gift Tax

Section 2501 imposes a tax for each calendar year on the transfer of property by gift during such calendar year by any individual.

Section 2511 provides that, subject to certain limitations, the gift tax applies whether the transfer is in trust or otherwise, direct or indirect, and whether the property transferred is real or personal, tangible or intangible.

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Section 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift. Section 2512(b) provides that where property is transferred for less than an adequate consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration is deemed a gift.

In this case, Trust will be divided into 12 separate trust shares. The dispositive provisions of the trust shares will generally be identical to the dispositive provisions of Trust, except that each trust share will be established for the benefit of a current income beneficiary and his/her family. However, the method for determining the amount to be paid to charity has been modified. Based on the facts submitted and the representations made and assuming the transaction is carried out as proposed and is effective under the law of State S, we conclude that the division of Trust into separate trust shares, as described above, will not result in a transfer by any of the beneficiaries that is subject to federal gift tax under § 2501. However, we are not ruling on the gift tax consequences of the modification of the method for determining the amount to be paid to charity.

Ruling Request #4: Power of Appointment:

Section 2041(a)(2) provides for the inclusion in the gross estate of any property over which the decedent possesses, at the time of his death, a general power of appointment created after October 21, 1942.

Section 2041(b)(1) provides that the term "general power of appointment" means a power that is exercisable in favor of the decedent, the decedent's estate, the decedent's creditors, or the creditors of the decedent's estate, except that a power to consume property for the benefit of the decedent that is limited by an ascertainable standard relating to health, education, support, or maintenance of the decedent is not deemed a general power of appointment.

Section 20.2041-1(b)(2) of the Estate Tax Regulations provides that the term power of appointment includes all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations. For example, if a trust instrument provides that the trust beneficiary may appropriate or consume the principal of the trust, the power to consume or appropriate is a power of appointment. A power in a donee to remove or discharge a trustee and appoint himself may be a power of appointment. For example, if under the terms of a trust instrument, the trustee or his successor has the power to appoint the principal of the trust for the benefit of individuals including himself, and the decedent has the unrestricted power to remove or discharge the trustee and appoint himself or herself as trustee, the decedent is considered as having a power of appointment. The mere power of management, investment, custody of assets, or the

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power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity whereby the holder has no power to enlarge or shift any beneficial interest therein, except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment. The term power of appointment does not include powers reserved by the decedent to himself within the concept of §§ 2036 to 2038.

In this case, two of the current transition trustees of the trust shares, Descendants F and K, are also income beneficiaries of their respective trusts. In addition, each has a right, at the end of the transition period, to designate themselves as the successor trustee of the trust share created for their individual benefit. Thus, for purposes of § 2041, Descendant F and Descendant K are treated as having the powers of the trustee over the trust shares for which they are the primary income beneficiaries. However, the trustees of the trust shares do not have the power to alter the distribution of trust share income or principal with respect to any individual beneficiary or to change any individual beneficiary. The only distributions that may be made to individual beneficiaries that are subject to the trustee's discretion, are distributions of income to a beneficiary who has not yet attained the age of majority and, in that situation, any discretionary distribution must be limited by ascertainable standards of health, education, support, and maintenance. In addition, the trustee will have the power to select the charitable beneficiary to receive the greater of the unitrust amount or trust share income.

Under the terms of the proposed trust shares, if a trustee is removed by unanimous vote of the trust share beneficiaries, only a corporate trustee with substantial trust assets under management may be appointed as the successor trustee and the appointment may only be made by the appropriate court.

Accordingly, we conclude that Descendant F and Descendant K will not be treated as possessing a general power of appointment for purposes of § 2041(b) over any of the trust shares, nor will any trust share beneficiary be treated as possessing a general power of appointment under § 2041(b) by virtue of a power to designate successor trustees.

A copy of this letter should be attached to any income, gift, estate, or generation-skipping transfer tax returns that you may file relating to this matter.

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 the appropriate party. While this office has not verified any part of the material submitted in support of the request for rulings, it is subject to verification and examination.

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Except as specifically ruled above, no opinion is expressed as to the federal tax consequences of the facts described above under the cited provisions or any other provisions of the Code or regulations.

This 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,

George Masnik
Chief, Branch 4
Office of Associate Chief Counsel

(Passthroughs and Special Industries)

Enclosure
copy for § 6110 purposes

cc:

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