

Internal Revenue Service

Department of the Treasury

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September 10, 1999

LEGEND

- Trust =
- Settlor =
- Spouse =
- Child =
- Grandchild A =
- Grandchild B =
- Great-Grandchild =
- A =
- B =
- C =
- D =
- E =
- F =
- Local Court =

This is in response to the March 2, 1999 letter and other correspondence in which rulings are requested on the application of the estate, gift, and generation-skipping transfer tax to a proposed settlement agreement regarding the Trust.

The Trust was created by the Settlor during life and became irrevocable at his death in 1981. No additions were made to the Trust after September 25, 1985. The individuals presently eligible to receive distributions from the Trust are Child, Grandchild A and Grandchild B (Child's adult children), and Great-

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Grandchild (Grandchild A's minor child).

Under Article II, paragraph 4, of the Trust agreement, the Trustees are authorized to pay to or for the benefit of any one or more of the living members of a class composed of Child and Child's lineal descendants part, all, or none of the net income and principal as the trustees deem proper for their "welfare." Spouse, who was included in the class of beneficiaries, died in 1995.

Under Article III, paragraph 2(a), the trustees are directed to make discretionary payments for a person's "welfare" from time to time in such amounts "as the Trustees deem proper for such person's support, health, education (including postgraduate education), advancement in life (including assistance in the purchase of a home or the establishment or development of any business or professional enterprise which the Trustees believe to be reasonably sound), lifetime residential or nursing home care and . . . general well-being even to the exhaustion of the trust." The Trustees are to make payments for an individual's welfare only to the extent the individual's income and funds available from others obligated to supply funds for the specified purposes are insufficient. The Trustees are also to take into account the individual's accustomed manner of living, age, health, marital status, and any other fact the trustees consider important in determining whether to make a distribution.

Article III, paragraph 2(b) provides that no trustee who is a beneficiary may make or participate in making any discretionary payment to or for the benefit of himself, or to or for the benefit of any co-trustee who is a beneficiary, for purposes other than health, support and education (including postgraduate education). No such trustee may terminate or participate in terminating any trust pursuant to the "Termination of Small Trust" provision or exercise any incident of ownership in a policy of insurance insuring his life or that of any co-trustee, but such incidents may be exercised by any other trustee who is not an insured or, if none, by a majority of the other beneficiaries to whom income may then be paid who are not insured. Further, no such trustee may make or participate in making any discretionary payment to or for any beneficiary such trustee or any co-trustee is then individually legally obligated to support which directly or indirectly discharges the obligation.

Under Article II, paragraph 5, at Child's death, the remaining Trust property is to be paid to, or retained in further trust for, such one or more of Child's lineal descendants as Child appoints in his will. Any principal not

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appointed by Child will be divided per stirpes and held in separate trusts for the Settlor's lineal descendants then living. Child and Child's lineal descendants are the Settlor's only lineal descendants.

Under paragraph 6 of Article II, if, at Child's death, Child fails to exercise the limited power of appointment, then the Trust property is to be divided on a per stirpes basis among Settlor's lineal descendants and held in further trust. The trustees are to pay to the beneficiary for whom a trust is held the net income and such amounts of principal as the trustees deem proper for the beneficiary's welfare. At age 30, the beneficiary is to receive one-half the trust principal and the balance at age 35. If the beneficiary dies before becoming entitled to all of the trust property, the then existing principal is to be paid to, or retained for, such one or more of the beneficiary's spouse and the Settlor's lineal descendants and their spouses as the beneficiary appoints. However, any trust must terminate no later than twenty-one years less one day after the death of the survivor of the Settlor's lineal descendants living at his death, and the principal is to be paid to the then current income beneficiary.

Under Paragraph 4 of Article IV there are to be three trustees, at least one of which is an independent trustee who is neither a beneficiary nor related to any beneficiary by blood or marriage. If a trustee ceases to act, the remaining trustees are to appoint a successor.

Spouse, Child, and A were initially designated as the trustees; however, Spouse and A resigned in 1987. B and C then became co-trustees with Child. In the exercise of their discretion, the trustees distributed \$20,000 monthly to Child, \$15,000 quarterly to Grandchild A, and \$15,000 quarterly to Grandchild B.

The Trust was funded with shares of a closely held corporation. In 1987, disputes began among the trustees concerning the management of the corporation. These disputes were resolved when the corporation was sold in 1992 to an outside purchaser. The Trust now consists primarily of marketable securities. However, disputes continued concerning the administration of the Trust and the extent of the beneficiaries' interests. A settlement plan (the Plan) was constructed to resolve these disputes. To implement the Plan, Child, B, and C resigned as trustees. D, E, and F are now the trustees.

Under the Plan, the periodic distributions will be increased so that Child will receive \$33,000 monthly instead of the \$20,000 he presently receives. Grandchild A and Grandchild B will each receive \$25,000 quarterly instead of the

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\$15,000 they presently receive. There will be one-time distributions of \$400,000 to Child; \$200,000 (less the outstanding amount of a loan from the Trust) to Grandchild A; and \$200,000 to Grandchild B. It is represented that these distributions are to be used in connection with the refurbishing of, purchase of, or payment of loans used to acquire residences by the respective beneficiaries.

The following payments will be made to or for the beneficiaries:

- (a) \$225,000 will be reimbursed to Child for legal fees incurred by child in connection with Trust prior to development of the Plan;
- (b) Up to \$130,000 will be paid for Grandchild A's legal fees incurred in connection with Trust prior to development of the Plan;
- (c) \$50,000 will be reimbursed to Grandchild A for education expenses incurred prior to the execution of the Plan;
- (d) \$65,000 will be reimbursed to Grandchild B for business and education expenses incurred prior to the execution of the Plan;
- (e) Up to \$185,000 will be paid for or reimbursed to Child for legal fees incurred by the beneficiaries in connection with the Plan or otherwise incurred by Child in connection with the Plan;
- (f) Up to \$35,000 will be paid for or reimbursed to Grandchild A for legal fees incurred in connection with the Plan (excluding advanced legal fees);
- (g) Up to \$35,000 will be paid for or reimbursed to Grandchild B for legal fees incurred in connection with the Plan (excluding advanced legal fees); and
- (h) Up to \$50,000 will be paid for or reimbursed to Child for costs of life insurance benefitting the Trust that were paid by Child.

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Finally, under the Plan, Child will release, in its entirety, the limited power of appointment provided for him in the Trust agreement.

As part of the Plan, the trustees will petition the Local Court to modify the Trust agreement to: (i) eliminate the requirement for three trustees; (ii) authorize the appointment of a single institutional trustee; (iii) authorize the removal of any trustee and designation of a successor institutional trustee at any time by a majority of the adult, legally competent beneficiaries; and (iv) authorize the adult legally competent beneficiaries to direct the trustee to employ and replace professional investment counsel.

The implementation of the Plan is subject to approval by Local Court.

Rulings requested

You have requested the following estate and gift tax rulings.

(1) Child's irrevocable release of the limited power of appointment will not cause section 2041 to apply to the Trust property at Child's death.

(2) Child's irrevocable release of the limited power of appointment will not be subject to gift tax.

(3) No beneficiary will be treated as holding a general power of appointment for purposes of section 2514 or section 2041 by reason of being authorized to participate in the removal of any trustee and the appointment of a qualifying bank or trust company as successor trustee.

You have requested the following generation-skipping transfer tax rulings.

(4) The proposed distributions and payments to or for Grandchild A and Grandchild B will not be subject to the generation-skipping transfer tax.

(5) The Trust will not cease to be exempt from the generation-skipping transfer tax by reason of the proposed distributions and payments to or for Child, Grandchild A, and Grandchild B.

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(6) The Trust will not cease to be exempt from the generation-skipping transfer tax by reason of Child's irrevocable release of the limited power of appointment.

(7) The Trust will not cease to be exempt from the generation-skipping transfer tax by reason of the modification of the Trust to reduce the required number of trustees, alter the procedure for appointing successor trustees, authorize the removal and replacement of the institutional trustee by a majority of the adult legally competent beneficiaries, and authorize the adult legally competent beneficiaries to direct the appointment and removal of investment counsel for the Trust.

ESTATE AND GIFT TAX: Ruling Requests 1, 2, and 3

Section 2041(a)(2) provides that the value of the gross estate shall include the value of all property to the extent of any property with respect to which the decedent has at the time of 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 the power of appointment by a disposition 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 sections 2035 through 2038 inclusive.

Section 2041(b)(1) defines the term "general power of appointment" as 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, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support or maintenance of the decedent shall not be deemed a general power of appointment.

Section 20.2041-1(b) of the Estate Tax Regulations provides that the mere power of management, investment, custody of assets, or the 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 of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment.

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Section 20.2041-1(c)(1) provides that a power of appointment is not a general power if by its terms it is either (1) exercisable only in favor of one or more designated persons or classes other than the decedent, the decedent's creditors, the decedent's estate, or the creditors of the decedent's estate, or (2) expressly not exercisable in favor of the decedent, the decedent's creditors, the decedent's estate, or the creditors of the decedent's estate. A power of appointment exercisable for the purpose of discharging a legal obligation of the decedent or for the decedent's pecuniary benefit is considered a power of appointment exercisable in favor of the decedent or the decedent's creditors.

Under section 2514(b), the exercise or release of a general power of appointment created after October 21, 1942, is deemed a transfer of property by the individual possessing the power, for gift tax purposes.

Section 2514 and the regulations thereunder provide rules similar to section 2041 and the applicable regulations with respect to the definition of a general power of appointment. See, e.g., section 2514(c) and § 25.2514-1(c).

Rev. Rul. 95-58, 1995-2 C.B. 191, holds that a grantor's reservation of an unqualified power to remove a trustee and appoint an individual or corporate successor trustee that is not related or subordinate within the meaning of section 672(c) to the grantor is not considered a reservation of the trustee's discretionary powers over the property transferred by the grantor to the trust. Accordingly the property in the trust would not be includible in the grantor's gross estate under section 2036 or section 2038.

In this case, Child's testamentary power of appointment may be exercised only in favor of his lineal descendants, and he may not exercise it in favor of himself, his creditors, his estate, or the creditors of his estate. Therefore, the power is a limited power of appointment rather than a general power of appointment as described in section 2041 and section 2514. Accordingly, Child's irrevocable and full release of the limited power of appointment will not cause the estate tax imposed under section 2041 to apply to the property comprising the Trust at Child's death. Likewise, Child's irrevocable and full release of his limited power of appointment will not be deemed a transfer subject to gift tax under section 2514.

The trustees propose to modify the Trust to authorize the removal of any trustee and replacement with a successor institutional trustee at any time by a majority of the adult legally competent beneficiaries. We conclude that,

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provided the modified Trust agreement requires a replacement trustee so designated to be neither subordinate nor related, within the meaning of section 672(c), to a beneficiary, no beneficiary will be treated as holding a general power of appointment for purposes of section 2514 or section 2041 by reason of the authority to participate in the removal of a trustee and the appointment of a qualifying bank or trust company as successor trustee.

GENERATION-SKIPPING TRANSFER TAX: Ruling Requests 4, 5, 6 and 7

Section 2601 provides that a tax is imposed on every generation-skipping transfer. Under section 1433(b)(2) of the Tax Reform Act of 1986, as amended, and § 26.2601-1(b)(1)(i) of the Generation-skipping Transfer Tax Regulations, the provisions of Chapter 13 will not apply to any generation-skipping transfer under a trust that was irrevocable on September 25, 1985. This rule does not apply to a portion of any generation-skipping transfer under an irrevocable trust where additions are made to the trust after September 25, 1985.

Section 26.2601-1(b)(1)(v)(A) provides that 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 transferred to the trust at the time of the release exercise or lapse.

Section 26.2601-1(b)(1)(v)(B) provides that the release, exercise, or lapse of a power of appointment (other than a general power of appointment as defined in section 2041(b)) will not be treated as an addition to a trust if –

- (1) The 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, the 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.

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A modification of a trust that is otherwise exempt for purposes of Chapter 13 by reason of section 1433(b)(2) of the Tax Reform Act will generally result in a loss of exempt status if the modification changes the quality value, or timing of any powers, beneficial interests, rights or expectancies originally provided for under the terms of the trust.

We believe that the terms of the settlement agreement (the Plan) in this case fairly reflect the relative merits of the positions of the respective parties to the disputes and are consistent with the beneficiaries' rights and trustees' powers under the instrument. Therefore, the settlement agreement does not alter the intended quality, value or timing of the interests created in the Trust. Accordingly, we conclude that: (1) the generation-skipping transfer tax will not apply to the Trust distributions and payments made to or for Grandchild A and Grandchild B; (2) the Trust will not cease to be exempt from the generation-skipping transfer tax by reason of the proposed distributions and payments; (3) Child's complete release of the limited power of appointment will not be treated as a constructive addition to the Trust, and the complete release of the testamentary limited power of appointment will not cause the Trust to become subject to the generation-skipping transfer tax; and (4) provided that the modification of trustee succession and investment counsel designation requires a replacement trustee to be neither subordinate nor related, within the meaning of section 672(c), to a beneficiary, the Trust will not cease to be exempt from the generation-skipping transfer tax by reason of the modification.

Except as ruled above, we express or imply no opinion concerning the federal tax consequences of this transaction under the cited provisions or any other provision of the Code.

This ruling letter 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,

Assistant Chief Counsel
(Passthroughs and Special Industries)

By _____
George Masnik
Chief, Branch 4

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