

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:4-PLR-102705-00
Date: July 21, 2000

Re:

Legend:

Trust =

Trust 1=

Trust 2 =

Successor trustee =

Spouse =
Husband =

Child 1 =
Child 2 =
Child 3 =

Attorney =

Date 1 =
Date 2 =
Date 3 =

State =

Dear :

This is in response to your letter dated July 11, 2000, and prior correspondence, in which you requested rulings regarding the gift and generation-skipping transfer tax consequences resulting from a proposed modification of Trust 2.

On Date 1, Spouse and Husband (Trustors) created an irrevocable trust, Trust. Spouse was designated as trustee of Trust, and Trust 1 and Trust 2 (discussed below) and currently serves in that capacity. On Date 2, the successor trustee, a corporate trustee, declined to act as successor trustee of Trust 2. On Date 3, Trustors' petitioned Superior Court of State to appoint an individual as successor trustee and the court approved the appointment of

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Successor trustee. It is represented that all of the property transferred to Trust 1 at the time it was created and funded consisted of Spouse's one-half (1/2) interest in the community property held by Spouse and Husband. It is further represented that all of property transferred to Trust 2 at the time it was created and funded consisted of Husband's one-half (1/2) interest in the community property held by Husband and Spouse.

Paragraph I of Trust provides that property is to be divided into two equal trusts, Trust 1 and Trust 2 for the primary benefit of Spouse during Spouse's life. Trust 1 is to consist of Spouse's one-half (1/2) community interest in certain property. Upon Spouse's death, the then remaining property of Trust 1 is to be divided into separate trusts for the benefit of Trustors' descendants.

Paragraph II of Trust provides that the net income of Trust 1 be distributed in monthly or other convenient installments to Spouse during life. In addition, Spouse is entitled to withdraw any amount at any time from the principal of Trust 1. The trustee has the absolute discretion to pay and distribute the principal to Spouse or any of Trustors' descendants for their proper support, education, medical treatment, maintenance, comfort, or care. Upon the death of Spouse, Trust 1 is to terminate and the then remaining principal together with any undistributed income, is to be distributed to such person or persons, including Spouse's estate, as Spouse appoints by will. If Spouse partially or wholly fails to exercise this power of appointment, any unappointed amount of Trust 1, including any undistributed income is to become part of Trust 2 and distributed in accordance with Paragraph III.

Paragraph III of Trust provides that the trustee is to distribute to Spouse all of the income and so much of the principal of Trust 2 as the trustee in its discretion determines to be proper for Spouse's support, medical treatment, maintenance, comfort, care having due regard to Spouse's other income and resources. However, Spouse, acting as trustee, may not make distributions to Spouse out of principal of Trust 2. The trustee may also distribute principal to any of descendants of Trustors for their proper support, education, medical treatments, maintenance, comfort or care. However, Spouse, acting as trustee, may only make these distributions to those persons to whom Spouse owes no obligation of support.

Paragraphs III 4. and 5. of Trust provide that upon the death of Spouse, the then remaining principal and any undistributed income of Trust 2 is to be divided in equal shares for the benefit of the surviving children of Trustors and for the issue of any deceased child by right of representation. Each share is to be held as a separate trust for the benefit of a child as follows: (a) net income is to be distributed in monthly or other convenient installments (but not less frequently than in annual installments) to the child during his or her lifetime; (b) the trustee has the absolute discretion to make distributions to the child out of principal for the child's proper support, education, medical treatment, maintenance, comfort, or care; (c) upon the death of the child the balance of the then remaining principal and any undistributed income of trust is to be divided in shares for the then living issue of the child by right of representation; and (d) if none of the issue survive the child, the balance of the principal and any undistributed income of trust is to be distributed to the then living issue of Trustors by right of representation, free and clear of all trusts, provided, however, that any share which would otherwise be distributed to a person for whom a trust created is then in existence is to be added to the trust and distributed as a part of that trust.

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Paragraphs III 6. and 7. of Trust provide that if any of the grandchildren of Trustors for whom a share has been set aside under Paragraphs III 4. and 5. attains: age 30, 1/3 of his or her share is to be delivered to him or her, free and clear of all trusts; age 35, 2/3 of his or her share is to be delivered to him or her, free and clear of all trusts; age 40, all of the share is to be delivered to him or her, free and clear of all trusts.

Each share of the trust set aside for the benefit of any of the grandchildren of Trustors under Paragraphs III 4. and 5. (except any portion of such share distributed to a grandchild free and clear of all trusts as provided in Paragraph 6) is to be distributed as follows: (a) until each of the grandchildren for whom a trust has been established attains age 21, the trustee is to pay grandchild so much of the net income for the proper health, support, maintenance, education, comfort, or care to grandchild. The balance of net income, if any, is to be accumulated by the trustee and added to the principal of grandchild's trust. Upon each of grandchildren attaining age 21, trustee is to pay currently to grandchild all of the net income from his or her trust until grandchild attains age 40 or dies, whichever event is first to occur; (b) when any grandchildren for whom a trust has been established attains: age 30, 1/3 of the then balance of the principal (and accumulated income) of his or her trust is to be delivered to him or her, free and clear of all trusts; age 35, 2/3 of the then balance is to be delivered to him or her, free and clear of all trusts; age 40, all of the then balance of principal (and accumulated income) is to be delivered to him or her, free and clear of all trusts; (c) the trustee has the absolute discretion to make distributions to child out of principal for child's proper support, education, medical treatment, maintenance, comfort, or care; (d) if at any time any trust contains less than \$10,000, the trustee may terminate trust and distribute the principal and accumulated income, if any, to the grandchild entitled to the distribution; (e) if any grandchild for whom a trust has been established dies prior to age 40, the trustee is to set aside all of the then balance of the principal and accumulated income of the deceased grandchild's trust in equal shares for the benefit of his or her surviving issue, if any, by right of representation. Each share set aside constitutes a separate and distinct trust and is to be distributed in the same manner as the other trust established under Paragraphs III 4. and 5. of Trust. If a grandchild leaves no surviving issue, then the balance of his or her trust is to be delivered to grandchild's then living brothers and sisters (and the issue of any deceased brother or sister by right of representation) in equal shares, or if the grandchild leaves no brothers or sisters or their issue surviving, then to the then living issue of Trustors by right of representation, provided, that any share which would otherwise be delivered to any person for whom a trust is created and is then in existence is to be added to and become part of the trust, to held, administered, and distributed as part of that trust; and (f) unless sooner terminated, each of the trusts provided for in Paragraph III will cease to terminate on the date which is 21 years after the date of death of the last survivor of Trustors and their issue living at the date of Trust. Upon termination, the entire principal of each of the trusts, together with any accumulated income, is to be distributed to the income beneficiaries for whom the property is then held in trust in proportion to their interests in income at that time.

Paragraph III 8. provides that if upon termination or failure of any trust because there is no issue of Trustors then living, the entire balance of the trust is to be distributed to the heirs-at-law of Trustors determined by the laws of succession of State then in effect relating to community property, and as if their simultaneous deaths had occurred upon the termination or failure of the trust.

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Spouse, in her capacity as trustee proposes to file another petition in the Superior Court of State to modify the successor trustee provisions. The petition proposes that if Spouse ceases to act as trustee of Trust 2, Child 1 is to be appointed successor trustee of Trust 2 and each trust created under Trust 2; if Child 1 fails or ceases to act as successor trustee, Child 2 is to be appointed successor trustee of Trust 2 and each trust created under Trust 2; if Child 2 fails or ceases to act as trustee, Child 3 is to be appointed successor trustee of Trust 2 and each trust created under Trust 2; and if Child 3 fails or ceases to act as trustee, Attorney is to be appointed successor trustee of Trust 2 and each trust created under Trust 2. In addition, the trustee, or any party in interest, will be authorized to petition the court for appointment of a trustee who is not related or subordinated to Trustors, the trustee-beneficiary, or any descendants of Trustors within the meaning of § 672(c) of the Internal Revenue Code, for the purpose of effecting the exercise of any power described in section 16081(c) of the State Probate Code which that section prohibits the trustee from exercising. It is represented that no additions have been made to Trust 2 after September 25, 1985.

In 1996, section 16081 of the State Probate Code was amended, effective January 1, 1997. Section 16081(c) provides, in part, that unless a settlor or a testator clearly indicates that a broader power is intended by express reference to this section, a person who is a beneficiary of a trust that permits the person, as trustee or co-trustee, to make discretionary distributions of income or principal to or for the benefit of himself or herself, may exercise that power in his or her favor only to provide for his or her health, education, support, or maintenance within the meaning of §§ 2041 and 2514 of the Internal Revenue Code.

Section 16081(e)(3) provides in part, that section 16081(c) applies to any irrevocable trust created under a document executed before January 1, 1997, unless the parties in interest elect affirmatively not to be subject to the application of subdivision (c) through a written instrument delivered to the trustee. The election shall be made on or before the latest of January 1, 1998, or three years after the date on which the trust became irrevocable. It is represented that none of the interested parties elected out of this provision by January 1, 1998 with respect to Trust 2.

The following rulings have been requested:

1. Under section 16081 of the State Probate Code if Child 1, Child 2, and Child 3 act as trustee of any trust created under Trust 2, these persons will not possess a general power of appointment under §§ 2041 or 2514 of the Internal Revenue Code with respect to the trust.

2. The proposed modification will not cause Trust 2 to lose status under section 1433 of the Tax Reform Act of 1986 as exempt from the application of the generation-skipping transfer tax under chapter 13 of the Code.

Ruling Request 1

Section 2501 of the Code imposes a tax on the transfer of property by gift by an individual. Section 2511 provides that the tax imposed by § 2501 applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

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Section 2514(b) provides that, for gift tax purposes, 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 the power.

Section 2514(c)(1) provides the term "general power of appointment" means a power that is exercisable in favor of the individual possessing the power (possessor), his estate, his creditors, or the creditors of his estate. However, a power to consume, invade or appropriate property for the benefit of the possessor that is limited by an ascertainable standard relating to the health, education, support or maintenance of the possessor is not a general power of appointment.

Section 2514(e) provides that the lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of the power to the extent that the property that could have been appointed by exercise of the lapsed power during the calendar year exceeds the greater of \$5,000 or 5 percent of the aggregate value of the assets out of which the exercise of the lapsed powers could be satisfied.

Section 25.2514-1(b)(1) of the Gift Tax Regulations provides that the term "power of appointment" includes all powers that are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations. If a trust instrument provides that the beneficiary may appropriate or consume the principal of the trust, the power to consume or appropriate is a power of appointment. Similarly, a power given to a donee to affect the beneficial enjoyment of trust property or its income by altering, amending or revoking the trust instrument or terminating the trust is a power of appointment. Further, a power in a donee to remove or discharge a trustee and appoint himself may be a power of appointment. For example, if the trustee or his successor has the power to appoint the principal of the trust for the benefit of individuals including himself and another person has the unrestricted power to remove or discharge the trustee at any time and appoint any other person including himself, that person is considered as having a power of appointment.

Section 25.2514-1(c)(2) provides that a power to consume, invade, or appropriate income or corpus, or both, for the benefit of the possessor of the power that is limited by an ascertainable standard relating to health, education, support or maintenance of the possessor is, by reason of § 2514(c)(1) not a general power of appointment. A power to use property for the comfort, welfare, or happiness of the holder is not limited by the requisite standard.

Section 25.2514-3(c)(4) provides that, if a trustee has, in his capacity as trustee, a power that is considered a general power of appointment, the trustee's resignation or removal as trustee will be considered a lapse of his power for purposes of § 2514(e).

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 such a power of appointment by a disposition that 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 to 2038, inclusive.

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Section 2041(b)(1)(A) provides that a general power of appointment is a power that is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate; however, a power to consume, invade, or appropriate property for the benefit of the decedent that is limited to the health, education, support, or maintenance of the decedent is not deemed to be a general power of appointment. Section 2041(b)(2) provides that the lapse of a power of appointment created after October 21, 1942, is considered a release of the power.

While federal law controls what rights or interests shall be taxed after they are created, creation of legal rights and interests in property (such as the breadth and scope of a power of appointment over the corpus of a testamentary trust) is a matter of state law. United States v. Pelzer, 312 U.S. 399 (1941), 1941-1 C.B. 441; Morgan v. Commissioner, 309 U.S. 78 (1940), 1940-1 C.B. 229.

As stated above, section 16081(c) of State Probate Code provides generally, that a person who is a beneficiary of a trust that permits the person, as trustee or cotrustee, to make discretionary distributions of income or principal to or for the benefit of himself or herself, may exercise that power in his or her favor only to provide for his or her health, education, support, or maintenance within the meaning of §§ 2041 and 2514 of the Code.

Rev. Proc. 94-44, 1994-2 C.B. 683, sets forth the Service's position regarding the transfer tax consequences of the enactment of Florida Statutes Annotated section 737.402(4)(a)(1). Under this statute, any fiduciary power conferred upon a trustee to make discretionary distributions of either principal or income to or for the trustee's own benefit cannot be exercised by the trustee, except to provide for that trustee's health, education, maintenance, or support, as described in §§ 2041 and 2514. The statute was effective with respect to trusts that were irrevocable on or after July 1, 1991. Pursuant to the revenue procedure, the Service will not treat the statute as causing the lapse of a general power of appointment for purposes of §§ 2041 and 2514, where the scope of a fiduciary power held by a beneficiary was restricted as a result of the statute.

We conclude that under section 16081(c) of State Probate Code, if Child 1, Child 2, or Child 3 becomes a trustee of Trust 2, or any trust created under the terms of Trust 2, such child will not possess a general power of appointment with respect to such trust for purposes of §§ 2041 and 2514, as a result of the trustee invasion power.

Requested Ruling 2

Section 2601 imposes a tax on every generation-skipping transfer made by a "transferor" to a skip person (a person assigned to a generation that is 2 or more generations below the generation assignment of the transferor) after October 22, 1986.

Section 1433(a) of the Tax Reform Act of 1986 (TRA of 1986) provides that 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 TRA of 1986 and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply 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), any trust in existence on September 25, 1985, will be considered an irrevocable trust unless the settlor

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possessed a power that would have caused the trust to be included in the settlor's gross estate under §§ 2038 or 2042, if the settlor had died on September 25, 1985. Section 26.2601-1(b)(1)(v) provides that where any portion of a trust remains in the trust after the release, exercise, or lapse of a general power of appointment and the release, exercise, or lapse is treated to any extent as a taxable transfer for estate and gift tax purposes, the value of the corpus subject to the power is treated as an addition to the trust after September 25, 1985.

A modification of a trust that is otherwise exempt for purposes of chapter 13 and the applicable regulations, will generally result in a loss of exempt or "grandfathered" 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 conclude that the proposed modification of the successor trustee provisions will not change the quality, value, or timing of any powers, beneficial interests, rights or expectancies originally provided for under the terms of Trust 2. Further, as discussed above, neither Child 1, Child 2, or Child 3 will possess a general power of appointment over Trust 2 corpus if she becomes trustee. Thus, we conclude that the proposed modification will not cause Trust 2 to lose any status under section 1433 of the Tax Reform Act of 1986 as exempt from application of generation-skipping transfer tax under chapter 13 of the Code.

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

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.

The rulings contained in this letter are directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Pursuant to the Power of Attorney on file, a copy of this letter is being sent to trustee of Trust 2.

Sincerely yours,

George L. Masnik
Chief, Branch 4

Enclosure

Copy for section 6110 purposes

cc: