

Internal Revenue Service

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Department of the Treasury

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Person to Contact:

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Refer Reply To:
CC:PSI:4 - PLR-140553-01
Date: July 31, 2001

Re:

Legend:

Taxpayers =

Decedent =

Spouse =

Son =

Daughter 1 =

Daughter 2 =

Daughter 3 =

Trust =

Court 1 =

Court 2 =

Individual =

Individual 2 =

Partnership =

Corporation =

Bank =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

Date 10 =

Year 1 =

Year 2 =

Dear _____ :

This is in response to a letter dated February 6, 2001, and prior correspondence, submitted on behalf of the Taxpayers, requesting rulings regarding the generation-skipping transfer tax consequences of a division of trust assets as described below.

Facts

The facts submitted and representations made are as follows: Decedent died prior to September 25, 1985, survived by his spouse (Spouse), his son (Son), and three daughters, Daughter 1, Daughter 2, and Daughter 3.

In his will, Decedent appointed Son as executor of his estate. Under Article Fifth of his will, Decedent devised and bequeathed the residue of his estate in trust and directed the trustee to divide the property into Trust A and Trust B. Son was named as initial trustee. During Spouse's life, the trustee was to pay her the net income from both trusts, as well as any amounts of principal the trustee deemed necessary for her support and maintenance. Spouse was given a testamentary general power of appointment over the assets of Trust A. To the extent she failed to exercise the power, the assets of Trust A were to augment Trust B.

Spouse died prior to September 25, 1985. She did not exercise her testamentary power of appointment. Therefore, under Decedent's will, any assets in Trust A at Spouse's death passed to Trust B, which is the subject of this ruling letter and hereinafter referred to as Trust.

Paragraph (4) of Article Fifth of Decedent's will provides as follows:

(4) Upon the death of my wife, [Spouse], Trust B (and Trust A to the extent that my wife shall make no different disposition thereof) shall continue and the net income therefrom shall be paid to my daughters, [Daughter 1, Daughter 2, and Daughter 3], in equal shares, share and share alike, for their respective lifetimes. If one or more of my said daughters shall fail to survive me, the share such predeceased daughter would have received shall be paid to her surviving issue by right of representation.

Upon the death of the last surviving daughter, this trust shall terminate and the corpus together with accrued and undistributed income shall be distributed to my grandchildren by right of representation, and including in this instance any lawful issue of my son, [Son].

Paragraph (5) of Article Fifth of Decedent's will (hereinafter referred to as the "income equalization provision") provides as follows:

If at any time after the death of my wife, [Spouse], and before the termination of my Trust Estate, the gross income from all sources in any one year of my son, [Son], shall be less than one-third (1/3) of the net income distributable under the Trust Estate during said year, the Trustee shall distribute to my said son an

amount of money sufficient to make his annual gross income equal to the share received from my Trust Estate during such year by each of my daughters (or their issue by right of representation if one or more of them shall have died).

On Date 1, Court 1 issued a Decree of Final Distribution of Decedent's estate. The Decree was filed with Court 2 Date 2.

Paragraph (4) of Article fifth of Decedent's will contains no direction as to the payment of a Daughter's share of Trust income if she should die during the Trust term without issue. Individual, as Trustee, petitioned Court 2 for a construction of the Trust and for instructions to the Trustee. Notice of the hearing on the petition was given as required by State law.

On Date 3, by Order Approving Petition for Construction of Trust Instrument and for Instructions to Trustee, Court 2 approved the resignation of Son and the appointment of Individual as Trustee. In the order, Court 2 construed Paragraph (4) of Article Fifth of Decedent's will as follows:

Upon the death of either [Daughter 1, Daughter 2, or Daughter 3], the share of the net income that would have been received by that deceased daughter pursuant to Paragraph (4) of Article Fifth on page 8 of the Will of [Decedent] shall be paid to her surviving issue by right of representation. In the event such deceased daughter is not survived by any issue, the share of the net income that would have been received by the deceased daughter shall be distributed to the survivor(s) of [Daughter 1, Daughter 2, or Daughter 3].

In the same order, Court 2 construed Paragraph (5) of Article Fifth of Decedent's will (the "income equalization provision") as follows:

... (a) [Son's] right to receive a distribution from the Trust each year shall be determined on (1) the gross income of [Son] for the previous year; and (2) the net income distributable for the Trust for the current year; (b) if [Son's] gross income for the previous year is less than one-third (1/3) of the Trust's net income distributable for the current year, then [Son] shall be entitled to receive a distribution from the Trust in an amount equal to seventy-five percent (75%) of the difference between (1) the Trust's net income distributable for the current year; and (2) [Son's] gross income for the previous year; (c) Any distribution from the Trust to [Son] shall reduce the amount to be distributed by the Trust to [Daughter 1, Daughter 2, and Daughter 3], or their successors, on a pro rata basis.

One of the primary assets of Trust from its inception until Year 1 was a limited partnership interest in Partnership. In Year 1, Partnership entered into a merger and recapitalization transaction in which Trust received stock in Corporation and cash in exchange for its interest in Partnership.

In Year 1, following the transaction, Daughter 3 filed suit against Individual as Trustee, seeking to remove Individual as Trustee and seeking reimbursement for damages. In the same year, Daughter 3 filed suit against Individual's attorneys with respect to services provided to Individual as Trustee. In Year 2, Corporation filed suit against Daughter 3, and Daughter 3 cross-claimed against Individual for indemnification.

On Date 4, upon Petition of Individual, as Trustee, for Instructions, Court 2 ordered that Trust income distributable to Son during the period January through April of each year shall be calculated ... based upon his gross income for the year which is 2 years before the current year. Thereafter his income distributions for the period May through December of each year will be adjusted to account for his actual gross income for the year before the current year.

On Date 5, all of the parties to the lawsuits listed above reached a global settlement of all claims raised in the suits and executed an Agreement of Compromise, Settlement and Release (Settlement Agreement).

In the Trustee's Petition for Approval of Settlement, the parties acknowledged that further clarification of the Trust was needed with respect to the disposition of Son's income interest in the Trust upon his death prior to the termination of the Trust because Paragraph (5) of Article Fifth of Decedent's will does not provide for this contingency. Thus, a question existed as to whether his income interest would pass to his children or to the other income beneficiaries. The Trustee committed himself to filing a petition for instructions from the court seeking an order that upon the death of Son during the Trust term, his children shall not succeed to his income interest but shall remain solely remainder beneficiaries.

On Date 6, Individual filed Trustee's Petition for Approval of Settlement with Court 2. Notice of the hearing on the petition, together with a copy of the Settlement Agreement, was mailed to each beneficiary of the Trust in accordance with State's probate code. Under State's probate code, any interested person could appear and make a response or objection at or before the hearing. Daughter 3's attorney appeared at the hearing representing Daughter 3 and her children. Court 2 appointed a guardian ad litem to review the petition on behalf of any unborn and ascertained issue of Son. Otherwise, no other Trust beneficiaries appeared at the hearing or filed any objections.

On Date 7, Court 2 issued two orders. The first order approved the Settlement Agreement. The second order instructed the Trustee that, following the death of Son, his heirs were not to receive income from the Trust during the lifetimes of Daughter 1 or Daughter 3, but were to receive their remainder interests in the Trust after the deaths of Daughter 1 and Daughter 3. (At this time, Daughter 2 was deceased and her two children were receiving her income interest in the Trust).

The Settlement Agreement in its entirety is incorporated into the Court's order by reference. The Settlement Agreement contains provisions modifying the Trust. The modifications to the Trust, as contained in the Court's order, are contingent upon the

Taxpayers' receipt of a favorable private letter ruling from the Service and are summarized as follows:

First, the Trust shall be modified to provide for the creation of a separate subtrust (Subtrust) solely for the benefit of Daughter 3 and her children. The Subtrust shall be maintained upon the same terms and conditions as the Trust, including, but not limited to, those terms and conditions concerning termination of the Trust. The Subtrust shall be funded with 1/4 of the Trust's shares in Corporation and 1/4 of all other assets of Trust.

Second, Daughter 3 and her children shall be the only persons who have the right to receive income, principal, or any other pecuniary, legal or equitable interest in any asset of the Subtrust. The income earned by the Subtrust shall not be considered in determining the income distribution to the income beneficiaries of the Trust. Daughter 3 and her children will not be entitled to the income from the Trust unless either of the following should occur:

- (1) If, during his lifetime, Son receives gross income that triggers the income equalization provision of the Trust, Daughter 3 (or her children if she is deceased and the Trust is not terminated), shall receive from the Trust an amount equal to 1/4 of Son's gross income; or
- (2) If Son predeceases Daughter 1 or Daughter 3 or both, Daughter 3 (or her children if she is deceased and the Trust is not terminated), shall receive 1/9 of all Trust income distributions.

Third, Daughter 3 and her children shall select as Trustee of the Subtrust an independent person who is not a member of their family. The Trustee of the Subtrust shall have the same powers with respect to the assets of the Subtrust, other than the Corporation stock, as those set forth in the Trust.

The Settlement Agreement provides that in funding the Subtrust, all assets of the Trust that can be divided into quarters will be so divided, so that 1/4 of those assets will be transferred to the Subtrust. Other assets which cannot be so divided will be pooled in the most commercially reasonable manner, and 1/4 of this pool will be transferred to the Subtrust.

The Settlement Agreement provides that if an amendment, alteration or modification of the Agreement involves solely the rights and terms of the Trust or Subtrust, such amendment, alteration or modification need only be signed by the Trustee, the Subtrustee, and each of Daughter 3 and her children. Under this provision, Bank, which had succeeded Individual as Trustee of the Trust, Individual 2, who had been named Trustee of the Subtrust (Subtrustee), and Daughter 3 and each of her children executed the First Amendment to the Settlement Agreement which related to the Trust's income distributable to Son under the income equalization provision of Decedent's will.

On Date 8, Daughter 3 filed a Petition for Construction of Trust, for Instructions and for Approval of Amendment to Settlement Agreement. The next day, Bank filed a Consent to the Petition.

On Date 9, all of the beneficiaries of the Trust were served with notice of a hearing to be held on the petition. Each beneficiary was served with a copy of the modified terms of the Trust and the Amendment to the Settlement Agreement and afforded an opportunity to object to them. No objections were filed.

On Date 10, Court 2 issued its order construing the Trust, instructing the Trustees and approving the Amendment to the Settlement Agreement. The effectiveness of the order is subject to the issuance of a favorable private letter ruling from the Service.

Under the new provisions that govern the Trust, until Daughter 1's death, the income of Subtrust will be distributed to Daughter 3 during her life and, at her death, will be distributed to the then-living issue of Daughter 3 by right of representation. Until Daughter 3's death, the income of the Trust will be divided into two equal shares. One share will be paid to Daughter 1 for life and, at her death, to her then-living issue by right of representation. The other share will be divided into two equal shares, one for each of the two children of Daughter 2. At the death of either child of Daughter 2, the deceased child's share will be paid to that child's then-living issue by right of representation. The provisions of Court 2's order of Date 3 continue to apply to construe the terms of the Trust. Thus, should either Daughter 1 or Daughter 3 die without issue while the other Daughter is still living, the deceased Daughter's share will be paid to the surviving Daughter until her death.

Upon the death of the survivor of Daughter 1 and Daughter 3, Subtrust and the Trust will terminate and be distributed outright. Subtrust will be distributed to Daughter 3's then-living issue, or, if none, will augment, equally, the shares distributed from the Trust. The Trust will be divided into three equal shares, Daughter 1's Share, Daughter 2's Share, and Son's Share. Daughter 1's Share and Daughter 2's Share will each be distributed to the respective Daughter's then-living issue, or, if none, will augment, equally, Subtrust and the other shares being distributed from the Trust. Son's Share will be distributed to the then-living lawful issue of Son, or, if none, will augment, equally, Subtrust and the other shares being distributed from the Trust.

The income equalization provision of Paragraph (5) of Article Fifth of Decedent's will is modified to ensure that Son and Daughters (or their issue) receive the share of income each would have received under the original terms of the Trust. The Court's order provides that, during the life of Son, if, in any year prior to the termination of the Trust, Son's gross income from other sources for the year immediately preceding the current year is less than $\frac{1}{2}$ of the Trust net income for the current year, the Trustee of the Trust shall distribute to Son an amount of cash or other comparable liquid assets sufficient so that, when added to his gross income from other sources for the prior year,

the sum thereof is equal to 1/3 of the sum of (1) the Trust's net income for the current year and (2) Son's gross income for the prior year.

Individual 2, who is not related to Daughter 3 or her children, will be the Subtrustee. The beneficiaries of Subtrust, acting by majority vote, may remove an acting trustee and may also appoint a trustee or co-trustees, if no trustee is then serving, who may be any person, or persons, other than a beneficiary, a beneficiary's spouse, or a person related or subordinate to a beneficiary within the meaning of § 672(c) of the Internal Revenue Code.

You have asked that we rule as follows:

1. After the proposed partition, Subtrust will be treated as a trust that was irrevocable on September 25, 1985, for purposes of § 1433(b)(2) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1) of the Generation-Skipping Transfer Tax Regulations.
2. The proposed partition of Trust into Subtrust and Trust will not constitute an actual or constructive addition to Subtrust under § 26.2601-1(b)(1)(v).
3. Neither the creation of Subtrust as a result of the proposed partition of Trust, nor distributions from Subtrust to its beneficiaries, including but not limited to distributions upon the termination of Subtrust, will be subject to the generation-skipping transfer tax.

Law

Section 2601 imposes a tax on each generation-skipping transfer (GST) made by a transferor to a skip person.

Under § 1433(a) of the Tax Reform Act of 1986, the generation-skipping transfer tax (GSTT) is generally applicable to generation-skipping transfers made after October 22, 1986. However, 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 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 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 GSTT will not cause the trust to lose its exempt status.

Section 26.2601-1(b)(4)(i)(D) provides that a modification will not cause an exempt trust to be subject to the GSTT 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 or the creation of a new GST.

In Commissioner v. Estate of Bosch, 387 U.S. 456 (1967), the Court considered whether a state trial court's characterization of property rights conclusively binds a federal court or agency in a federal estate tax controversy. The Court concluded that the decision of a state trial court as to an underlying issue of state law should not be controlling when applied to a federal statute. Rather, the highest court of the state is the best authority on the underlying substantive rule of state law to be applied in the federal matter. If there is no decision by that court, then the federal authority must apply what it finds to be state law after giving "proper regard" to the state trial court's determination and to relevant rulings of other courts of the state. In this respect, the federal agency may be said, in effect, to be sitting as a state court.

Rev. Rul. 95-58, 1995-2 C.B. 191, concludes that a settlor's retained power to remove a trustee and appoint an individual or corporate trustee or successor that is not related or subordinate to the settlor (within the meaning of § 672(c)), will not be considered retention of the trustee's discretionary powers for purposes of §§ 2036 and 2038.

Analysis

Trust was irrevocable prior to September 25, 1985. You represent that there have been no constructive or actual additions to Trust since September 25, 1985.

Subtrust and Trust will be administered under the original terms of Trust as provided in Decedent's will, as construed and modified by the orders of Court 2 on Date 3, Date 7, and Date 10.

The new provisions governing income payments to Daughters and their issue are intended to ensure that the same beneficiaries will receive the same shares of income they would have received under the original terms of Trust as construed by Court 2 on Date 3. We believe that the Court's construction of the Trust in its order on Date 3 was a reasonable interpretation of Decedent's intent with respect to the payment of Trust income following the death of a daughter without surviving issue.

The new income equalization provision is modified to ensure that the same beneficiaries among Son and Daughters (or their issue) receive the same shares of income they would have received under the original terms of the Trust as construed by Court 2 on Date 3 and Date 4. These new provisions do not effectively change the original terms of the Trust as construed by these orders. Moreover, we believe the Court's instructions concerning the provision and the method for calculating the amount

of Trust income which should be distributed to Son under the provision represent reasonable interpretations of Decedent's intent in including the provision in his will.

Subtrust and Trust will terminate at the death of the last survivor of Daughters, when Trust would have terminated under its original terms. The original terms of Trust provide that, when the Trust terminates, the remaining Trust assets will be "distributed to [Decedent's] grandchildren by right of representation, and including in this instance any lawful issue of [Son]." Under the new provisions, when Subtrust and Trust terminate, Trust will be divided into three equal shares, one for Daughter 1 and her issue, one for Daughter 2 and her issue, and one for Son and his issue. The share for Daughter 1 and the share for Daughter 2 will each be distributed to the respective Daughter's then-living issue, or, if none, will augment, equally, Subtrust and the other shares being distributed from Trust. Similarly, Subtrust will be distributed among the then-living issue of Daughter 3, or, if none, will augment, equally, the share for Daughter 1, the share for Daughter 2, and the share for Son. Son's share will be distributed to the then-living lawful issue of Son, or, if none, will augment, equally Subtrust and the other shares being distributed from the Trust.

Based on an analysis of the applicable case law, we believe that the new provisions for the distribution of Subtrust and Trust upon their termination represent a construction of the original terms of Trust that is consistent with applicable state law as it would be applied by the highest court of the state. Therefore, these new provisions ensure that, upon the termination of Subtrust and Trust, the trusts will be distributed among the same beneficiaries as under the original terms of Trust.

Court 2's order of Date 10 provides administrative provisions for Subtrust and provisions governing the removal and appointment of trustees of Subtrust. Although these provisions were not contained in the original provisions of Decedent's will, they create no new powers or benefits in any beneficiary. Under these new provisions, the beneficiaries of Subtrust can remove and replace trustees (or co-trustees) with persons who are not a beneficiary of Subtrust, spouse of such beneficiary, or who are not subordinate or related to such beneficiary within the meaning of § 672(c).

We conclude that, for purposes of § 26.2601-1(b)(4)(i)(D), the modification of the terms of Trust by Court 2 does not shift any beneficial interest in the Trust to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the modification. Further, 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.

Accordingly, based on the facts submitted and the representations made, and provided that the partition of Trust into Subtrust and Trust is a valid partition under applicable state law, we rule as follows:

1. Subtrust will be treated as a trust that was irrevocable on September 25, 1985, for purposes of § 1433(b)(2) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1) of the Generation-Skipping Transfer Tax Regulations.

2. The proposed partition of Trust into Subtrust and Trust will not constitute an actual or constructive addition to Subtrust under § 26.2601-1(b)(1)(v).

3. Neither the creation of Subtrust as a result of the proposed partition of Trust , nor distributions from Subtrust to its beneficiaries, including but not limited to distributions upon the termination of Subtrust, will be subject to the generation-skipping transfer tax.

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.

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,
Associate Chief Counsel
(Passthroughs and Special Industries)
By: Katherine A. Mellody
Senior Technician Reviewer
Branch 4

Enclosure

Copy for section 6110 purposes