

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:2-PLR-109027-01
Date:
August 17, 2001

LEGEND:

Testator:

Trust:

Trustee:

Daughter:

Grandson:

Granddaughter:

Great Granddaughter 1:

Great Granddaughter 2:

Great Granddaughter 3:

Great Grandson:

Disinherited Grandson:

Court 1:

Court 2:

State:

date 1:

date 2:

date 3:

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date 4:

date 5:

date 6:

date 7:

date 8:

date 9:

date 10:

a:

b:

c:

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Dear Trustee:

We received a letter and subsequent correspondence from your representative

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submitted on your behalf requesting rulings regarding the continuing need to maintain the Trust reserve fund and any generation-skipping transfer tax consequences under § 2601, et. seq. of the Internal Revenue Code resulting from reallocating the income paid into the Trust reserve fund among the Trust beneficiaries. This letter responds to your request.

Testator executed her will on date 1, amended the will on date 2 and died on date 3. Testator's executrix offered the will for probate in Court 1. On date 4, Court 1 ordered the establishment of Trust, for the benefit of Daughter, Grandson, Granddaughter, the issue of Granddaughter, and the issue of Disinherited Grandson. Testator appointed Trustee as the sole trustee. The Trustee represents that no additions, actual or constructive, have been made to the Trust since date 4. Grandson died without issue on date 5. Daughter died on date 6.

Currently, the Trust income is distributed annually as follows: a percent to the reserve fund, b percent to Granddaughter who takes because Daughter is deceased; a percent to Granddaughter; c percent to the blood Issue of Granddaughter (Great Granddaughter 1 and Great Grandson); a percent to the living blood issue of Disinherited Grandson (Great Granddaughter 2); d percent divided equally between Great Granddaughter 3 and Granddaughter who take because Grandson is deceased.

At the time of the Testator's death, the Trust owned several pieces of real property, comprising approximately e percent of the Trust's value. In the exercise of its powers conferred by the Trust, the Trustee has sold all but one of the pieces of real property originally in the Trust. The remaining property has a current fair market value of approximately \$f. The balance of the reserve fund was \$g and the value of the Trust was \$h on date 7.

The Trustee believes that the purpose of the reserve fund was to pay any extraordinary expenses related to the management of the real property. The terms of the Trust require the Trustee to maintain the a percent reserve fund as a separate account until the Trust terminates. The Trust does not indicate whether the reserve fund must continue to be held and increased if the Trust no longer either holds any real property or uses the reserve fund. It is represented that the reserve fund has not been used in at least the last i years, and that the Trustee has concluded that it is no longer necessary to maintain the reserve fund.

The "Total Residue" section of the Trust provides that the Testator's estate shall go to the Trustee in trust, as sole trustee, for the following purposes: to be administered according to the terms and provisions as set hereunder.

Paragraph 1 of the "Income" section of the Trust provides that a percent of the net income, i.e., total income less taxes and expenses applicable thereto, shall be set aside each month. This accumulated income is to be used for unusual and unexpected operating expenses or Assessments (not Capital) and the like deemed to be for the

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best interest of the Trust by the Trustee.

Paragraph 2 of the "Income" section of the Trust provides, in part, that b percent of the net income, i.e., total income received less taxes and expenses applicable thereto, shall be paid over annually to Daughter. And in the event of the death of Daughter, prior to the termination of this Trust, the portion of net income which would have gone to Daughter had she lived to take, shall go to Granddaughter.

Paragraph 3 of the "Income" section of the Trust provides, in part, that a percent of the net income, i.e., total income received, less taxes and expenses applicable thereto, shall be paid over annually to Granddaughter.

Paragraph 4 of the "Income" section of the Trust provides, in part, that c percent of the net income, i.e., total income received, less taxes and expenses applicable thereto, shall be paid over annually to the then living blood issue children of Granddaughter on an equal basis.

Paragraph 5 of the "Income" section of the Trust provides, in part, that a percent of the net income, i.e., total income received less taxes and expenses applicable thereto, shall be paid over annually to the then living blood issue children of Disinherited Grandson on an equal basis. In the event of the death of either of Disinherited Grandson's blood issue children, the share such deceased child would have taken had he or she lived to take shall go by way of representation to the then living blood issue of such child and if there be no blood issue of such deceased child to take, then this share shall go to his or her then living surviving brother(s) or sister(s) or their issue by way of representation.

Paragraph 6 of the "Income" section of the Trust provides, in part, that d percent of the net income, i.e., total income received less taxes and expenses applicable thereto, shall be paid over annually to Grandson. Upon the death of Grandson prior to the termination of this Trust, the portion of net income which would have gone to Grandson, had he lived shall be disposed of in the following manner: This share (d percent of the net income) shall be divided into two equal parts. One part shall go to the Adopted Daughter of Grandson. The other part shall go to the blood issue of Grandson by way of representation. And if there be no blood issue of Grandson to take then this part shall go to Granddaughter if living and if not living then to her blood issue by way of representation.

The "Income" section of the Trust further provides that this Trust is to terminate in any event not later than twenty (20) years after the death of the last survivor of the following persons living at the date of Testator's death: Daughter; Grandson; Granddaughter; Great Granddaughter 1; Great Granddaughter 2; Great Grandson; any other blood issue children of Granddaughter not herein named then living and any blood issue children of Great Granddaughter 2 not herein named then living. Otherwise the maximum life of this Trust is forty (40) years. At the expiration of the life of this

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Trust, the corpus and any undistributed income (including the a percent reserve fund set out in paragraph 1 of the "Income" section) shall be distributed and paid out as follows: (a) c percent to Granddaughter, (b) n percent to the blood issue children of Granddaughter, (c) a percent to the living blood issue children of Disinherited Grandson, (d) m percent to Grandson.

On date 8, Trustee filed a petition in Court 2 requesting that Court 2, under the provisions of State probate code: 1) construe the Trust in order to clarify the terms of the Trust; 2) modify the Trust to eliminate the requirement for the annual funding of a reserve fund; and 3) allow the Trustee to add to the remaining Trust corpus the income accumulated in the reserve fund. In particular, Trustee requested Court 2 to: 1) revoke paragraph 1 of the income section of Trust in its entirety and all subsequent references thereto under the distributive provisions that follow; and 2) authorize and direct the Trustee to add to the Trust principal the reserve balance now on hand and to pay therefrom to the income beneficiaries as part of the income distributions under the Trust all future income derived from the principal, in the same proportion to one another as set forth in Trust.

By Court 2 orders on date 9, and date 10, retroactive to date 9, Court 2 ordered: 1) that Trustee be relieved from the Trust requirement to fund the annual reserve fund; 2) that Trustee be authorized to add the existing reserve fund to Trust principal and to pay therefrom to the income beneficiaries as part of the income distributions under Trust all future income derived from said principal, in the same proportion to one another as set forth in Trust; and 3) that Court 2's order would be operative only upon the issuance of a letter or other document by the IRS approving the changes effective in Court 2's order as not affecting the exempt status of the Trust for GST tax purposes.

Under Court 2's order, the annual income that otherwise would have gone to reserve fund is to be paid to the income beneficiaries in the same proportion as the income they currently receive. The percentages of Trust net income that beneficiaries would receive after the modifications is as follows: j percent to Granddaughter who takes because Daughter is deceased; k percent to Granddaughter; l percent to the blood Issue of Granddaughter (Great Granddaughter 1 and Great Grandson); k percent to the living blood issue of Disinherited Grandson (Great Granddaughter 2); m percent divided equally between Great Granddaughter 3 and Granddaughter who take because Grandson is deceased.

The percentage of Trust corpus that each beneficiary will receive at the Trust's termination will remain unchanged. Upon Trust's termination, the accumulated income will be added to the corpus and the entire amount of the Trust will be distributed as follows: c percent to Granddaughter; n percent to the blood Issue of Granddaughter (Great Granddaughter 1 and Great Grandson); a percent to the living blood issue of Disinherited Grandson (Great Granddaughter 2); m percent divided equally between Great Granddaughter 3 and Granddaughter who take because Grandson is deceased.

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You have requested the following rulings:

1. Adding the accumulated reserve fund income to the Trust corpus will not constitute an “addition” to the Trust, and

2. Reallocating the payment of a percent of net income paid to the reserve fund among the various beneficiaries is not a type of modification which will cause the Trust to lose its exemption from the GST Tax.

Section 2601 imposes a tax on every generation-skipping transfer (GST) (within the meaning of subchapter B).

Section 2602 provides that the amount of the GST tax imposed by § 2601 is the taxable amount multiplied by the applicable rate.

Section 2611(a) provides that the term “generation-skipping transfer” (GST) means--(1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 2612(c)(1) provides that for purposes of chapter 13 the term “direct skip” means a transfer subject to a tax imposed by chapter 11 or 12 of an interest in property to a skip person.

Section 2613(a) provides that the term “skip person” means--(1) a natural person assigned to a generation that is two or more generations below the generation assignment of the transferor, or (2) a trust--(A) if all interests in the trust are held by skip persons; or (B) if--(i) there is no person holding an interest in the trust, and (ii) at no time after the transfer may a distribution (including distributions on termination) be made from the trust to a non-skip person.

Section 26.2601-1(a)(1) of the Generation-Skipping Transfer Tax Regulations provides that except as otherwise provided in § 26.2601, the provisions of chapter 13 of the Internal Revenue Code of 1986 (Code) apply to any generation-skipping transfer (as defined in § 2611) made after October 22, 1986.

Section 26.2601-1(b)(1)(i) provides that the tax does not apply to any generation-skipping transfer under a trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985. The rule of the preceding sentence does not apply to a pro rata portion of any generation-skipping transfer under an irrevocable trust if additions are made to the trust after September 25, 1985. See § 26.2601-1(b)(1)(iv) for rules for determining the portion of the trust that is subject to the provisions of chapter 13.

Section 26.2601-1(b)(1)(ii) provides that, except as provided in § 26.2601-1(b)(1)(ii)(B) (property includible in the gross estate under § 2038) or (C) (property includible in the gross estate under § 2042), any trust in existence on September 25, 1985, is considered an irrevocable trust.

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Section 26.2601-1(b)(1)(iv) provides that if an addition is made after September 25, 1985, to an irrevocable trust which is excluded from chapter 13 by § 26.2601-1(b)(1), a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the provisions of chapter 13.

Section 26.2601-1(b)(1)(vi) provides that except to the extent that the provisions of Section 26.2601-1(b)(1)(iv) and (v) allocate subsequent appreciation and accumulated income between the original trust and additions thereto, appreciation in the value of the trust and undistributed income added thereto are not considered an addition to the principal of a trust.

Section 26.2601-1(b)(4) 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)(1), (b)(2), or (b)(3) will not cause the trust to lose its exempt status. The rules of § 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. They 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 of the Code.

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 provisions of chapter 13, 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 of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy § 26.2601-1(b)(4)(i)(A), (B), or (C) of this subsection) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, but only if--(1) 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 (2) 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 a generation-skipping trust that is otherwise exempt under § 26.2601-1(b)(1)(i) will not result in a loss of its exempt or "grandfathered" status, if the trust meets the requirements of § 26.2601-1(b)(4).

Based on the information submitted, the representations made, and the Court 2 orders of date 9, and date 10, we conclude that if no additions, actual or constructive, have been made to Trust after September 25, 1985, the GST tax does not apply to

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Trust, because Trust was an irrevocable trust on September 25, 1985 within the meaning of § 26.2601-1(b)(1)(i) and meets the requirements of § 26.2601-1(b)(4). We also conclude that: 1) combining the accumulated reserve fund income with the Trust corpus will not constitute an “addition” to the Trust; and 2) the reallocation of the a percent of net income paid to the reserve fund among the various beneficiaries is not a type of modification which will cause the Trust to lose its exemption from the GST Tax.

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 letter 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.

Pursuant to a power of attorney on file with this office, a copy of this letter is being forwarded to Trustee’s authorized representative.

Sincerely,
Christine E. Ellison
Branch Chief, Branch 3
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes