

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:4/PLR-110766-01
Date:

MAY 22, 2002

In Re:

Legend:

- Grantor -
- Son -
- Spouse -
- Granddaughter 1 -
- Granddaughter 2 -
- Trust #1 -

- Trust #2 -

- Trust #3 -

- Trust #4 -

- Trust #5 -

- Trust #6 -

- Trust #7 -
- Trust #8 -
- Trust #9 -

- Trust #10 -

- Trust #11 -

- Trust #12 -

- Trust #13 -

- Trust #14 -

- Trust #15 -

- Trust #16 -

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Trust #17 -

Trust #18 -

Trust #19 -

Trust #20 -

Trust #21 -

Trust #22 -

Trust #23 -

Trust #24 -

Trust #25 -

Trust #26 -

Company -

LLC1 -

Date 1 -

Date 2 -

Dear :

This is in reference to your request for rulings regarding the effect of proposed distributions to Trusts #1 through #26 for federal income and generation-skipping transfer (GST) tax purposes.

Facts

The facts submitted are as follows:

Company elected in 1999 to be treated as an S corporation for federal income tax purposes. Company has accumulated earnings and profits from periods prior to 1999. Company has 32 shareholders. Fifty three percent of the stock in Company is owned by Trusts #1 through #26, which were established between and by Grantor, Grantor's son (Son), the spouse of Son (Spouse), and the granddaughters of Grantor (Granddaughter 1 and Granddaughter 2) for the benefit of various descendants of Grantor. Granddaughters 1 and 2 are also shareholders of Company. The remaining 4 shareholders are other trusts (not at issue in this ruling request) established by one of the granddaughters. All of the individual trustees of Trusts #1 through #26 are descendants of Grantor. In addition, an independent corporate trustee is a co-trustee of Trusts #1 through #8, and Trusts #18 and #19. A major asset of each of the trusts is stock in Company.

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It is represented that: Trusts #1 through #8 and Trusts #18 and #19 qualify as shareholders of Company as electing small business trusts (ESBTs); Trusts #9 through #17 qualify as shareholders of Company as qualified subchapter S trusts (QSST Trusts); and Trusts #20 through #26 are grantor trusts, within the meaning of Subpart E, Part I, Subchapter J, Chapter 1, Subtitle A of the Internal Revenue Code of 1986.

Trusts #1 - #19:

Trusts #1 through #4 are either inter vivos or testamentary trusts that were created by Grantor primarily for the benefit of Granddaughters 1 and 2 and their issue. Trusts #5 through #8 are either inter vivos or testamentary trusts that were created by Son also primarily for the benefit of Granddaughters 1 and 2 and their issue. Likewise, Trusts #9 through #19 are either inter vivos or testamentary trusts that were created by Spouse primarily for the benefit of Granddaughters 1 and 2 and their issue. Trusts #1 through #19 do not contain any provision directing the allocation of receipts between income and principal. Trusts #1 through #19 are governed by Maryland law and were irrevocable prior to September 25, 1985. It is represented that no additions have been made to any of Trust #1 through Trust #19 after September 25, 1985.

Trusts #20 - #23:

Trusts #20 through #23 are irrevocable trusts that were established on Date 1, after September 25, 1985, by Granddaughter 1, primarily for the benefit of her issue and their descendants. You represent that Granddaughter 1 allocated sufficient GST exemption so that Trusts #20 through #23 each has an inclusion ratio of zero for generation-skipping transfer tax purposes. These trusts are also governed by Maryland law. Art. III(G)13 of each trust states that:

Fiduciary Powers. In addition to the powers granted by law, I grant my Trustee the powers set forth in the Estates and Trusts Article of the Maryland Code, as well as the powers set forth in the following paragraphs, which is subject, however, to the restrictions set forth in the following Paragraphs H, I, and J of this Article. My Trustee (hereinafter sometimes referred to as "fiduciary") is empowered, in its discretion as a fiduciary and without the order or ratification of any court: . . .

13. To determine whether items should be charged or credited to income or principal or allocated between income and principal, in such manner as the Trustee deems equitable and fair under all the circumstances, without regard to how such items are treated for federal estate or income tax purposes, . . .

Further, the Maryland Uniform Principal and Income Act (Md. Code Ann., Est. & Trusts, § 15-508 (2001)) provides, in part:

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(c) *Receipts allocated to principal.* - Except as provided in subsection (f) of this section, a trustee shall allocate the following receipts from an entity to principal:

- (1) Property other than money;
- (2) Money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity; . . .

Trusts #24 - #26:

Trusts #24 through #26, are irrevocable trusts established on Date 2, after September 25, 1985, by Granddaughter 2 primarily for the benefit of her issue and their descendants. You also represent that Granddaughter 2 allocated sufficient GST exemption so that Trusts #20 through #23 each has an inclusion ratio of zero for generation-skipping transfer tax purposes. Trusts #24 through #26 are governed by New Jersey law. Art. III(G)(13) of each trust states that:

Fiduciary Powers. In addition to the powers granted by law, I grant my Trustee the powers set forth in the New Jersey Statutes, as well as the powers set forth in the following paragraphs, which shall be subject, however, to the restrictions set forth in the following Paragraphs H, I, and J of this Article. My Trustee (hereinafter sometimes referred to as "fiduciary") is empowered, in its discretion as a fiduciary and without the order or ratification of any court: . . .

13. To determine whether items should be charged or credited to income or principal or allocated between income and principal, in such manner as the Trustee deems equitable and fair under all the circumstances, without regard to how such items are treated for federal estate or income tax purposes, . . .

Further, New Jersey law provides that, where the trust instrument makes provision for the ascertainment of principal and income or grants discretion to the fiduciary or other person to do so, the provision or the grant of discretion shall control, notwithstanding any provision in the New Jersey statute. N.J. Stat. Ann. § 3B:19A-5(a) (West 2001).

The shareholders of Company created LLC1, a limited liability company, in 2000. The shareholders' membership interests in LLC1 are in the same proportion as their respective shares in Company. It is represented that, to date, no capital contributions have been made to LLC1 by its members.

Proposed Transaction

Company proposes to create a second limited liability company (LLC2) in which Company will initially be the sole member. Upon the creation of LLC2, Company will

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contribute property and cash to LLC2 in an amount not in excess of its accumulated adjustments account, as defined in § 1368(e)(1) of the Internal Revenue Code. Company will then distribute its interest in LLC2 to its shareholders in proportion to each of the shareholders' stock holdings in Company. The trustee of each of the Trusts will allocate the LLC2 interests received to principal. LLC2 will then merge into LLC1 with LLC1 as the surviving entity. All of these transactions will occur in quick succession.

Rulings Requested

You have requested the following rulings:

1. The proposed transaction will not constitute an addition to Trusts #1 through #19 that would subject Trusts #1 through #19 or distributions from those trusts to the generation-skipping transfer tax imposed under § 2601 of the Internal Revenue Code.
2. The proposed transaction will not result in a change in the inclusion ratio of Trusts #20 through #26 for generation-skipping transfer tax purposes.
3. The proposed transaction will not cause the QSST Trusts to have trust accounting income which must be distributed to their respective beneficiaries as required by the QSST rules.

Law and Analysis

Rulings #1 and #2:

Section 2601 imposes a tax on every generation-skipping transfer (GST) made after October 26, 1986.

A generation-skipping transfer is defined under § 2611(a) as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip. Section 2612(a) provides that the term taxable termination means a termination (by death, lapse of time, release of a power, or otherwise) of an interest in property held in trust where the property passes to a skip person with respect to the transferor of the property. Section 2612(b) provides that the term taxable distribution means any distribution from a trust to a skip person other than a taxable termination or a direct skip. Under § 2612(c)(1), a direct skip is a transfer subject to federal estate or gift tax made by a transferor to a skip person.

Under § 1431(a) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the GST tax does not apply to any generation-skipping transfer under a trust that was irrevocable on September 25, 1985. However, this exemption does not apply to additions (actual or constructive) that are made to the trust after September 25, 1985.

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Section 26.2601-1(b)(1)(iv) states that, if an addition is made after September 25, 1985, to a trust which was irrevocable on September 25, 1985, a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the GST tax provisions. If an addition is made, the trust is thereafter deemed to consist of two portions, a portion not subject to the GST tax and a portion subject to the GST tax.

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 will not cause the trust to lose its exempt status.

Section 26.2601-1(b)(4)(i)(D)(1) provides that a modification of a trust by judicial reformation or nonjudicial reformation that is valid under applicable state law will not cause the trust to lose its GST exempt status if the modification does not shift any beneficial interest in the trust to a lower generation beneficiary 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. Under § 26.2601-1(b)(4)(i)(D)(2), a modification of an exempt trust will result in a shift in beneficial interests to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST 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.

Under § 2602, the amount of the tax imposed under § 2601 is equal to the taxable amount multiplied by the applicable rate. The applicable rate is defined in § 2641 as the maximum federal estate tax rate multiplied by the inclusion ratio with respect to the transfer. Under § 2642(a), in general, the inclusion ratio with respect to any property subject to a generation-skipping transfer is the excess of one over the applicable fraction determined for the trust from which the transfer is made. The applicable fraction with respect to a trust is a fraction, the numerator of which is the amount of GST exemption under § 2631 allocated to the trust, and the denominator of which is the value of the trust property, with certain specified adjustments.

Under § 2631, each individual is allowed an exemption of \$1,000,000 (adjusted for inflation) which may be allocated by such individual (or by his or her executor) to any property with respect to which such individual is the transferor for GST purposes.

In the present case, Trusts #1 through #19 were irrevocable on September 25, 1985. It is represented that no additions, actual or constructive, have been made to any of those trusts after that date. Trusts #20 through #26 were created after September 25, 1985. It is represented that sufficient GST exemption was allocated to

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Trusts #20 through #26 such that these trusts have an inclusion ratio of zero.

Under the proposed transaction, assets held by Company will be transferred to LLC2 and proportionate interests in LLC2 will be distributed to Trusts #1 through #26 as shareholders of Company. It is represented that the LLC2 interests received by the trusts are properly allocated to principal pursuant to the terms of the trusts, and, if the trusts are silent regarding allocation of receipts, pursuant to state law. After the transaction (including the merger of LLC2 into LLC1), each trust will maintain the same proportionate interest in the assets initially distributed by Company. The proposed transaction effectuates a change in the form of investment or interests held by the trusts and is administrative in nature. Accordingly, the proposed transaction will not be considered to result in a shift of any beneficial interest in any of the trusts to a lower generation beneficiary or an extension of the time for vesting of any beneficial interest in any of the trusts beyond the period provided for in the original trusts. Similarly, the proposed transfers will not be deemed to be additions to the trusts for generation-skipping transfer tax purposes.

Based on the facts submitted and the representations made, we conclude that the proposed transaction will not constitute an addition to Trusts #1 through #19 that would subject Trusts #1 through #19 or distributions from those trusts to the federal generation-skipping transfer tax imposed under § 2601, nor will the proposed transaction cause these trusts to lose GST exempt status under the rules contained in § 26.2601-1(b)(4)(i).

Similarly, we also conclude that the proposed transaction will not result in a change in the inclusion ratio of Trusts #20 through #26 for generation-skipping transfer tax purposes.

Ruling #3:

You have requested a ruling on whether the proposed transaction will cause the QSST Trusts to have trust accounting income which must be distributed to their respective beneficiaries as required by the QSST rules.

Section 1361(d)(3) defines the term QSST as a trust whose terms require that: (i) during the life of the current income beneficiary, there will be only one income beneficiary of the trust; (ii) any corpus distributed during the life of the current income beneficiary may be distributed only to that beneficiary; (iii) the income interest of the current income beneficiary in the trust will terminate on the earlier of the beneficiary's death or the termination of the trust; and (iv) upon the termination of the trust during the life of the current income beneficiary, the trust will distribute all of its assets to the beneficiary. Section 1361(d)(3)(B) further defines a QSST as a trust all of the income of which is distributed (or required to be distributed) currently to one individual who is a citizen or resident of the United States.

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Section 1.1361-1(j)(1)(i) of the Income Tax Regulations provides that the income of the trust that must be distributed (or is required to be distributed) currently, is income within the meaning of § 1.643(b)-1. Section 1.643(b)-1 provides that for purposes of subparts A through D, part I, subchapter J, chapter 1 of the Code, the term income when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of an estate or trust for the taxable year determined under the terms of its governing instrument and applicable local law.

Section 15-508 of the Maryland Uniform Principal and Income Act, which is the governing law of the QSST Trusts, provides that a trustee shall allocate to income money received from an entity, and that a trustee shall allocate to principal property other than money received from an entity.

Section 301.7701-3(a) provides that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes. Elections are necessary only when an eligible entity does not want to be classified under the default classification or when an eligible entity chooses to change its classification.

Section 301.7701-3(b)(1)(ii) provides that, unless the entity elects otherwise, a domestic eligible entity is disregarded as an entity separate from its owner if it has a single owner.

The distribution of the LLC2 interests to the QSST Trusts is a distribution of property allocable to principal under Maryland law. Therefore, the receipt of the LLC2 interests by the QSST Trusts will not be considered a receipt of income to the trusts for § 1361(d)(3)(B) purposes. As the receipt of the LLC2 interests is not income to the QSST Trusts, the proposed transaction will not cause the QSST Trusts to fail to qualify as QSSTs if they do not distribute the LLC2 interests to the beneficiaries of those trusts.

During the time Company is the sole member of LLC2, LLC2 will be treated as a disregarded entity for federal tax purposes. Therefore, the transfer of assets to LLC2 has no federal tax consequences. Company's distribution of the LLC2 interests to its shareholders will be considered a distribution of the property and cash held by LLC2 followed by a contribution of the property and cash to LLC2 by the shareholders. The distribution of the LLC2 interests by Company (treated as a distribution of LLC2's property and cash) will be subject to §§ 1368 and 311(b). Furthermore, the shareholders of Company will be treated as contributing the property and cash to LLC2 under § 721.

Except as specifically set forth 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. Specifically, no opinion is expressed whether Company is an S corporation or whether the QSST Trusts otherwise qualify as QSSTs.

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

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 of the material submitted in support of the request for rulings, it is subject to verification on examination.

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,
George Masnik
Chief, Branch 4
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure
Copy for section 6110 purposes

cc: