

Internal Revenue Service

Department of the Treasury

Number: **200314011**
Release Date: 4/4/2003
Index Number: 2601.00-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:4-PLR-133053-02
Date: DECEMBER 20, 2002

Re:

Legend:

Decedent =

Spouse =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8=

Child 1 =

Child 2 =

Child 2's Spouse =

Child 1's Trust =

Child 2's Trust =

Grandchild 2a =

Grandchild 2b =

Grandchild 2c =

Court =

Final Decree =

State =

State Statute 1 =

State Statute 2 =

Dear :

This is in response to a letter dated December 10, 2002 and prior correspondence in which you requested a ruling concerning the generation-skipping transfer ("GST") tax consequences of the reformation of Child 2's Trust, as described below.

Facts

The facts are submitted and represented to be as follows: Decedent died testate on Date 1, prior to September 25, 1985, survived by his wife (Spouse) and two children, Child 1 and Child 2. Decedent's will and three codicils were admitted to probate on Date 2.

Decedent's will provided for the establishment of a Marital Trust for the benefit of Spouse to be funded based on a marital deduction formula amount. Under Article VI.B of the will, the remainder of the estate was to be divided into two separate shares to be administered as two separate trusts, Child 1's Trust, and Child 2's Trust. Child 1's Trust is held for the benefit of Child 1 and his descendants and Child 2's Trust is held for the benefit of Child 2 and his descendants.

Article VI B. 1,2 and 3 of Decedent's will provide the dispositive terms of Child 1's Trust. Pursuant to Article VI. B. 4, the provisions of Article VI B.1, 2 and 3 are also to apply (with appropriate substitution of the beneficiaries) with respect to Child 2's Trust. Accordingly, under Article VI B.1 and Article VI. B.4, Child 2's Trust is to be held for the benefit of Spouse, Child 2, Child 2's Spouse, Child 2's children and their descendants. The net income of the trust is to be paid to the trust beneficiaries in such amounts and at such times as the trustees shall determine in their sole discretion. The trustees can, in their discretion, accumulate, rather than distribute, income. Under Article VI B.2 and Article VI. B.4, the trustees also have the discretion to distribute principal to the trust beneficiaries as the trustees consider necessary to meet any special need or emergency of any such beneficiary, such as, without limitation, illness, accident, educational requirements, including college and graduate school education, and

insufficiency of income to provide a decent standard of living. The trustees are not required to equalize principal distributions among the beneficiaries.

Child 2's Trust will terminate twenty-one (21) years following the death of the last to die of Decedent, Spouse, and Child 2. Upon termination the trust corpus is to be distributed to Child 2's descendants per stirpes; provided that, if Child 2 survives Decedent, the trust is to be distributed to Child 2's descendants in such manner and in such proportions as Child 2 appoints by will.

On Date 3, within 9 months of Date 1, and also prior to September 25, 1985, Spouse disclaimed her entire interest in the Marital Trust by filing a disclaimer with Court. It is represented that under state law and the terms of Decedent's will, as a result of the disclaimer, the property otherwise bequeathed to the Marital Trust passed as part of the estate residue to Child 1's Trust and to Child 2's Trust. Consequently the Marital Trust was never created. Also on Date 3, Child 2 and Child 2's Spouse disclaimed all of their respective interests in Child 2's Trust by filing disclaimers with Court. Specifically, Child 2 disclaimed all interest in income and principal beneficially owned by him (whether as a beneficiary, as a donee of a testamentary special power of appointment, or otherwise) in his trust and all rights to serve as trustee of his trust. Child 2's Spouse disclaimed all interest in income or principal beneficially owned by her in Child 2's Trust.

Decedent's will, as amended by codicil, names Child 1 and Child 2 as trustees under the will. The codicil provides that the named trustees (Child 1 and Child 2) shall be entitled to appoint one or more individuals and or any bank or trust company to serve as co-trustees with and to succeed them, or should either named trustee continue to serve and at any time resign, die or otherwise cease to serve, the remaining trustee or trustees shall be entitled to appoint a bank or individual as successor trustee. At the time that Decedent's will was admitted to probate, only Child 1 qualified as the sole trustee of Child 2's Trust. On Date 4, pursuant to a final decree entered by Court, Child 1 resigned as trustee and Court appointed Grandchild 2a, Grandchild 2b, and Grandchild 2c, as successor co-trustees.

The current beneficiaries of Child 2's Trust are Spouse, Grandchild 2a, Grandchild 2b, Grandchild 2c and their descendants ("Current Beneficiaries").

On Date 6, Child 2's Spouse was appointed by Court as independent trustee (Independent Trustee) to serve with the co-trustees of Child 2's Trust. Also by Court's order, issued on Date 7 and modified on Date 8 (hereinafter "Final Decree"), Child 2's Trust was reformed, as of Date 5, as follows:

1. Modification of Definition of Income. As used in [Decedent's] Will, the term "income" with respect to [Child 2's] Trust (or any separate trust created after the division of [Child 2's] Trust provided below) shall be modified to refer in each instance to the greater of: (a) the income of

[Child 2's] Trust (or any separate trust created after the division of [Child 2's] Trust provided below), and (b) five percent of the Average Net Fair Market Value of the trust assets determined as of the first day of the taxable year of the trust. (The Average Net Fair Market Value of the trust assets shall be the average of the value of the trust assets determined as of the last day of each of the preceding twelve quarters.) Notwithstanding the foregoing, the above modification shall not apply in determining the amount of any distribution to any beneficiary who at the time of the distribution has an ancestor living who is a descendant of [Child 2]. In no event shall total distributions from [Child 2's] Trust in any taxable year of the trust under Article VI.B.1 of the Will (as applied to [Child 2's] Trust by Article VI.B.4 of the Will) exceed the greater of: (a) the income of [Child 2's] Trust (or any separate trust created after the division of [Child 2's] Trust provided below), and (b) five percent of the Average Net Fair Market Value of the trust assets as defined above.

In addition, the Final Decree modifies the terms of the Decedent's will regarding Child 2's Trust to provide that all powers of distribution from the trust to the trust beneficiaries shall be vested in a trustee called the "Independent Trustee." The Independent Trustee is: (i) an individual who is not a current beneficiary, or a person legally obligated to support a current beneficiary, of Child 2's Trust (or any separate trust created after the division of Child 2's Trust (discussed below); (ii) a bank; or (iii) a corporation or other entity with trust powers. Under the will as modified, there shall always be an Independent Trustee. Child 2's Spouse is designated as the first Independent Trustee.

Finally, the Final Decree divides Child 2's Trust into three separate sub-trusts: Grandchild 2a's Trust; Grandchild 2b's Trust; and Grandchild 2c's Trust. Under the court order, until the termination of the trusts, Grandchild 2a's Trust is to be held for the benefit of Spouse, Grandchild 2a, and the descendants of Grandchild 2a. Grandchild 2b's Trust is to be held for the benefit of Spouse, Grandchild 2b, and the descendants of Grandchild 2b. Grandchild 2c's Trust is to be held for the benefit of Spouse, Grandchild 2c, and the descendants of Grandchild 2c.

Upon termination, Grandchild 2a's Trust is to be distributed to Grandchild 2a, if then living, and if not then living to his then living descendants, per stirpes; Grandchild 2b's Trust is to be distributed to Grandchild 2b, if then living, and if not then living to his then living descendants, per stirpes; and Grandchild 2c's Trust is to be distributed to Grandchild 2c, if then living, and if not then living to his then living descendants, per stirpes. The subtrusts will terminate at the same time as provided under the terms of Child 2's Trust.

Grandchild 2a, Grandchild 2b, Grandchild 2c and the Independent Trustee will all serve as co-trustees of each new subtrust, such that each subtrust will have 4 co-

trustees.. The three separate subtrusts are to be funded on a pro-rata basis with one-third of the assets of Child 2's Trust distributed to each subtrust.

State Statute 1 permits modification of a trust for good cause as long as the modification neither materially impairs the accomplishment of the trust purposes nor adversely affects the interests of any beneficiary. Under State Statute 1, good cause for modification is shown if the modification would benefit the trust or the interests of any beneficiary of the trust.

State Statute 2 provides that the property interest disclaimed passes as if the person making the disclaimer predeceased the decedent, unless the decedent has made other provisions in the will for the disclaimed property. Under State Statute 2, the disclaimer shall relate back for all purposes to the date of death of the decedent.

Child 2's Spouse, as Independent Trustee, requests the following rulings:

1. The modification pursuant to the Final Decree of the distribution provision of Child 2's Trust will not affect the exempt status of Child 2's Trust for GST tax purposes.
2. The division of Child 2's Trust into three separate subtrusts, one for the benefit of Spouse, Grandchild 2a and his descendants, one for the benefit of Spouse, Grandchild 2b and his descendants, and one for the benefit of Spouse, Grandchild 2c and his descendants, will not affect the exempt status of the three subtrusts for GST tax purposes.

Discussion

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

Under § 1433(a) of the Tax Reform Act of 1986, 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 Tax Reform 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 generation-skipping transfer tax will not cause the trust to lose its exempt status. The regulation provides that the rules contained in the paragraph are applicable only for purposes of determining whether an exempt trust retains its exempt

status for generation-skipping transfer tax purposes. The rules 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.

Section 26.2601-1(b)(4)(i)(D)(1) and (2) provides that a modification will not cause an exempt trust to be subject to the provisions of chapter 13, 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 will not result in the shift of a beneficial interest to a lower generation beneficiary if the modification does not result in an increase in the amount of a GST transfer or the creation of a new GST transfer.

In the present case, the Final Decree modified Child 2's Trust to provide that the term "income" with respect to Child 2's Trust will be defined as the greater of the income of Child 2's Trust (or any separate trust created after the division of Child 2's Trust), and five percent of the average net fair market value of the trust assets determined as of the first day of the taxable year of the trust. However, under the Final Decree, the modification only applies with respect to distributions to the beneficiaries who, at the time of the distribution, do not have an ancestor living who is a descendant of Child 2. Thus, the modification can operate to increase distributions over amounts currently authorized under Article VI. B.2. of the trust only with respect to those beneficiaries (currently Spouse, Grandchild 2a, Grandchild 2b and Grandchild 2c.) Accordingly, the reformation will not operate to shift a beneficial interest in the trust to any beneficiary who occupies a generation lower than the persons holding the beneficial interest prior to the reformation and will not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in Child 2's Trust. Cf. § 26.2601-1(b)(4)(i)(E), Example 8. Therefore, the modification of the distribution provision pursuant to the Final Decree order will not affect the exempt status of Child 2's Trust for GST tax purposes.

In addition, the division of Child 2's Trust into three separate subtrusts, one for the benefit of Spouse, Grandchild 2a and his descendants, one for the benefit of Spouse, Grandchild 2b and his descendants, and one for the benefit of Spouse, Grandchild 3b and his descendants, will not affect the exempt status of the three subtrusts for GST tax purposes. See § 26.2601-1(b)(4)(i)(E), Example 5.

The ruling contained in this letter is 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 the ruling, 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. We are specifically expressing no opinion regarding the termination date of Child 2's Trust in view of Child 2's disclaimer, the gift tax consequences under § 2514 regarding the appointment of the independent trustee, and the gift and income tax consequences of the reformation.

The ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,

George L. Masnik
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Office of Associate Chief Counsel
(Passthroughs and Special
Industries)

Enclosure
Copy for section 6110 purposes