

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact:

Telephone Number:

Refer Reply To:

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Date: JULY 15, 2004

In Re:

LEGEND:

Grantor =

Date 1 =

Date 2 =

Son =

Probate Court =

Trust =

a =

Dear :

This is in response to your December 31, 2003 letter and other correspondence requesting a ruling concerning the generation-skipping transfer (GST) tax consequences of a proposed conversion of a trust.

You have requested the following ruling:

The proposed reformation of the trust to the “total return concept” of investment and disbursement will not result in the trust losing its exempt status for GST tax purposes.

The facts submitted are as follows:

Grantor executed Trust on Date 1 (before September 25, 1985) for the benefit of his son, Son. Article Second, section a, provides that after paying, or making provisions for, all necessary and proper charges incident to the trust, the Trustee shall accumulate all net income as a part of the corpus until such time as Son shall attain the age of 30 years and, thereafter during the lifetime of Son, to pay over to him the entire net income in quarterly installments as nearly equal in amount as circumstances will permit.

Article Second, section b, provides that upon the death of Son, the trustee will divide the entire corpus, including any undistributed income, into such parts so that each of his children shall share equally therein, the child or children of any deceased child representing their parent per stirpes, and to hold one of said parts as a separate trust for each of said children, with all the powers and authority hereinafter set forth, disbursing the net income and corpus thereof as follows:

- (1) By paying over to the duly appointed guardian or guardians of the child or children of any deceased child, share and share alike, the share to which said deceased child would have been entitled if living.
- (2) By accumulating, in whole or in part, the net income on the share of any child of my son who may be a minor, or by paying the same, or any part thereof, over to a duly appointed guardian of said child, for its support, maintenance, as in the sole judgment of my trustee may from time to time appear advisable.
- (3) By paying over to each of Son's children upon his or her attaining the age of 21 years, the entire net income on his or her share, in quarterly installments, until such time as said child attains the age of 25 years, at which time his or her entire share shall be paid over, freed and discharged of all trusts.

Article Second, section c, provides that should any child of Son die before final distribution of the share set aside to him, said share shall be paid over to his lineal descendants per stirpes and not per capita. Should there be no lineal descendants, the share of such child shall go to the remaining child or children of Son, share and share alike, as though the same had been a part of the original share set aside to them upon the death of Son.

Article Second, section e, provides that the trustee may (but shall not be required to do so, except in its sole discretion) from time to time, in case of emergency, the existence of which the trustee shall be the sole judge, use all or any part of the corpus for the benefit and welfare of Son, or any lineal descendant, at the time participating in the income hereunder.

Article Second, section f, provides that the trust, or trusts, herein provided for shall cease and determine 21 years after the death of the last survivor of Grantor's children and grandchildren who shall be alive at Grantor's death, and, when the trust or trusts so cease and determine, the persons presumptively entitled, under the foregoing provisions, to any part of the principal, shall, by force of this provision, become absolutely entitled thereto.

Article Ninth provides that Trust is irrevocable and no part of the corpus of Trust or any income shall ever, under any circumstances, either directly or indirectly inure to Grantor's benefit.

The trustee petitioned Probate Court to reform Trust under the “total return concept.” Pursuant to the proposed reformation:

Article Second, section a, will provide, in relevant part, that after paying or making provisions for, all necessary and proper changes incident to Trust, the trustee shall pay, distribute or disburse, to or for the benefit of Son, for and during his lifetime, in each calendar year of this Trust, an amount equal to a% of the average of the fair market value of the Trust as of the close of the last business day of the Trust’s three previous calendar years, or the net income, whichever is greater and is hereinafter referred to as the “distribution amount.”

Article Second, section a, part 2, will provide that all computations of the Trust’s fair market value shall include accounting income and principal, but no accruals shall be required. If the Trust includes assets for which there is not a ready market, the Trustee shall adopt a method of evaluation as the Trustee deems reasonable in its discretion under the circumstances.

Article Second, section a, part 3, will provide that the distribution amount from the Trust shall be paid first from net accounting income, next from net realized short-term capital gains, then from net realized long-term capital gains, and as necessary, from the principal of Trust.

Article Second, section a, part 6, will provide, in pertinent part, that the trustee shall have the discretion to modify the a% distribution rate as trustee may deem necessary, with the approval of the Probate Court or such other court as in the future may have jurisdiction over this Trust. Such a change in rate shall be within the power of the Court to approve, based upon the request for approval of the Corporate Trustee, given the instrument and distribution goals of this Trust. No individual trustee shall have such power.

Article Second, section a, part 7, will provide that the distribution amount shall be paid in quarterly as nearly equal in amounts as circumstances will permit.

Sections b – f of Article Second remain unchanged. The proposed reformation will also add section g to Article Second, which provides investment powers to the trustee.

On Date 2, Probate Court ordered that Trust be reformed, pending a favorable letter ruling from the Internal Revenue Service.

LAW AND ANALYSIS

Section 2601 of the Internal Revenue Code imposes a tax on every generation-skipping transfer (GST), which is defined under section 2611 as a taxable distribution, a taxable termination, or a direct skip.

Under section 1433 of the Tax Reform Act of 1986 (the Act), GST tax is generally

applicable to generation-skipping transfers made after October 22, 1986. However, under section 1433(b)(2)(A) of the Act and section 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, except to the extent the transfer is made out of corpus added to the trust by an actual or constructive addition after 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 under section 26.2601-1(b) will not cause the trust to lose its exempt status. These rules are applicable only for purposes of determining whether an exempt trust retains 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 section 1001.

Section 26.2601-1(b)(4)(i)(D) provides that a modification will not cause an exempt trust to be subject to the GST tax if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 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 a beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a generation-skipping transfer or the creation of a new generation-skipping transfer.

Section 26.2601-1(b)(4)(i)(E), Example 8, illustrates a situation where a trust that is otherwise exempt from the GST tax provides that trust income is payable to A for life and, upon A's death, the remainder is to pass to A's issue, per stirpes. In 2002, the appropriate local court approves a modification to the trust that converts A's income interest into the right to receive the greater of the entire income of the trust or a fixed percentage of the trust assets valued annually (unitrust interest) to be paid each year to A for life. The example concludes that the modification does not result in a shift in beneficial interest to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. Rather, the modification can only operate to increase the amount distributable to A and decrease the amount distributable to A's issue. In addition, 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. Therefore, the modification will not subject the trust to the provisions of chapter 13.

In this case, the proposed modification of Trust to provide for the distribution to Son an amount equal to a% of the average of the fair market value of the Trust as of the close of the last business day of the Trust's three previous calendar years, or the net income, whichever is greater, does not result in a shift of any beneficial interest in Trust

to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the modification. See section 26.2601-1(b)(4)(i)(E), Example 8. Further, the modification does not extend the time for vesting of any beneficial interest in Trust beyond the period provided for in the original Trust.

Accordingly, based on the facts submitted and the representations made, we conclude that the proposed reformation of the trust to the “total return concept” of investment and disbursement will not result in the trust losing its grandfathered status for GST tax purposes.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. We are specifically not ruling on the gift tax and income tax consequences of the transaction.

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.

This 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,

Lorraine E. Gardner
Senior Counsel, Branch 4
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure:

Copy of letter for section 6110 purposes