

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:B04-PLR-100129-02
Date: JULY 10, 2002

In re:

Legend:

- Son =
- Mother =
- Father =
- Stepmother =
- Trust 1 =

- Trust 2 =

- Trust 3 =

- Trust 4 =

- Spouse 1 =
- Spouse 2 =
- Trustee =
- Date 1 =
- Date 2 =
- Date 3 =
- Date 4 =
- a =
- b =
- c =
- d =
- e =
- f =
- State =
- State Law 1 =
- State Law 2 =
- State Law 3 =
- Rev. Rul. 1 =
- Citation 1 =
- County Court =

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Dear _____ :

This is in response to your December 20, 2001 letter and other correspondence requesting rulings concerning the generation-skipping transfer (GST) status of Trusts 1-4.

The rulings requested are as follows:

1. Trust 1, Trust 2, Trust 3, and Trust 4 are wholly exempt from the GST tax under section 1433(b)(2)(A) of the Tax Reform Act of 1986 because the trusts became irrevocable before September 25, 1985 and no additions (actual or constructive) have been made to the trusts since that date.
2. The exercise by Son of his testamentary power of appointment over Trusts 1-4 will not be considered to be an addition (actual or constructive) to the trust in question.
3. The trustee's proposed investment of substantially all of the assets of Trusts 1-4 in the LLC will not cause the four trusts to lose their GST tax exempt status, because the change of investment is within the powers of the trustee.
4. The trustee's proposed investment of substantially all of the assets of Trusts 1-4 in the LLC will not cause any portion of any of the four trusts to be treated as if it had been added to any of the four trusts after September 25, 1985.
5. The modification of the provision of Trust 1 regarding the payment of the trustee's fees will not cause Trust 1 to lose its GST exempt status.

The facts submitted are as follows:

Mother died testate on Date 1, prior to October 21, 1942. Item 7 of Mother's will provided for the establishment of Trust 1 for the benefit of Son. Under the terms of Trust 1, after Son attains the age of 28, all trust income is to be distributed to Son for life. On Son's death, the corpus is to be distributed to such persons as Son may appoint by will. In default of appointment, the corpus is to be distributed to Son's descendants per stirpes.

Item 8 of Mother's will provides that the trustee shall have full power to invest the trust estate and reinvest and change investments of the trust estate from time to time in its discretion.

Item 11 of Mother's will provides that the trustee shall be allowed for its services a commission of not over a per cent of the trust income.

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In a series of written agreements, all executed prior to November 1, 1951, Son partially released his general power of appointment over Trust 1. Son retained the testamentary power to appoint Trust 1 corpus, outright or in trust, to specified beneficiaries. Son is currently living and is the sole current income beneficiary of Trust 1.

Trust 2 was created by Father on Date 2 (prior to October 21, 1942) for the benefit of his wife (Stepmother) and his children. Trust 3 was created by Stepmother on Date 2. Trust 4 was created by Father on Date 2 for the benefit of his mother and Son. Son is the sole current income beneficiary of Trust 2, Trust 3, and Trust 4. Under the terms of each trust, all trust income is required to be distributed to Son. Under the terms of each trust, Son is granted a power to dispose of the principal of each trust at the time of his death by will, to and among such person or persons as Son shall designate. Specifically, each trust instrument grants Son the power to dispose of the principal of any property held in trust for him at the time of his death, "by last will and testament, to and among such person or persons or for such objects and purposes and in such manner and proportions, in trust or otherwise, as he or she shall designate to take the same." None of the trusts specifically authorized Son to appoint the property to his creditors or his estate. Each trust provided the trustee with full power to invest, reinvest, and change investments.

Son and Spouse 1 signed a separation agreement as part of divorce proceedings on Date 3 (after November 1, 1951 and before September 25, 1985). In the separation agreement, Son partially released his special power of appointment over Trust 1, retaining a testamentary power to appoint half of the Trust 1 property to the children of his marriage to Spouse 1, and the other half to a specified list of donees. Son also partially released his power of appointment with respect to Trust 2, Trust 3, and Trust 4 retaining a special testamentary power to appoint property of the respective trusts to the children of his marriage to Spouse 1.

The separation agreement also mandated that Son pay as alimony to Spouse 1 a sum of \$b (\$c if Spouse 1 remarried) annually. If the net income that Son receives from the four trusts should increase or decrease by more than d% each year, then the alimony payment to Spouse 1 is to be adjusted accordingly.

It is represented that no actual or constructive additions to Trusts 1-4 have been made since September 25, 1985. Currently, Trustee serves as the trustee for all four trusts.

The trustee proposes to form a new limited liability company (LLC) in order to provide greater income for Son while preserving the principal for the remainder beneficiaries. Trusts 1-4 would be the sole members of LLC and the trustee will serve as general manager. Each trust would contribute substantially all of its assets to LLC as its capital contribution and each trust would receive an interest in the LLC that

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corresponds to the size of its capital contribution when compared to the other LLC members.

The LLC operating agreement would provide that the LLC be required to make cash distributions to Trusts 1-4 each year in an amount equal to the greater of: (a) e percent of the average fair market value of the LLC assets valued as of the close of business on the last business day of each of the three preceding calendar years; and (b) the net income of the LLC determined under State Law 1 and determined as if the LLC were a trust. The trusts would then distribute the cash to Son.

The LLC operating agreement would prohibit the LLC from making cash distributions in any one year in excess of the greater of (a) f percent of the average fair market value of the LLC assets valued as of the close of business on the last business day of each of the three preceding calendar years and (b) the net income of the LLC determined under State Law 1 and determined as if the LLC were a trust.

Trustee petitioned County Court requesting authorization to invest trust assets in the LLC, as outlined above. In addition, Trustee requested that Item 11 of Mother's will be modified to adjust the compensation payable to the trustee. On Date 4, County Court issued an order authorizing the investment of trust assets in the LLC, subject to IRS approval. The court also ordered that Item 11 of Mother's will is to be modified to provide that a corporate trustee shall be entitled to receive reasonable compensation for its services in accordance with its published rates and schedules regardless of the value of Trust 1.

LAW AND ANALYSIS

Rulings 1 and 2

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

Under section 1433(a) of the Tax Reform Act of 1986 (Act) and section 26.2601-1(a) of the Generation-Skipping Transfer Tax Regulations, the 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), the tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added). However, this rule does not apply to a transfer of property pursuant to the exercise, release, or lapse of a general power of appointment that is treated as a taxable transfer for estate or gift tax purposes.

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Section 26.2601-1(b)(1)(v)(A) provides that, except as provided under section 26.2601-1(b)(1)(v)(B), where any portion of a trust remains in the trust after the post-September 25, 1985, release, exercise, or lapse of a power of appointment over that portion of the trust, and the release, exercise, or lapse is treated to any extent as a taxable transfer for estate or gift tax purposes, the value of the entire portion of the trust subject to the power that was released, exercised, or lapsed is treated as if that portion had been withdrawn and immediately retransferred to the trust at the time of the release, exercise, or lapse.

Section 26.2601-1(b)(1)(v)(B) provides a special rule for certain powers of appointment. This section provides that the release, exercise, or lapse of a power of appointment (other than a general power of appointment as defined in section 2041(b)) will not be treated as an addition to a trust if -- (1) such power of appointment was created in an irrevocable trust that is not subject to Chapter 13 under section 26.2601-1(b)(1); and (2) in the case of an exercise, such power of appointment is not exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date of creation of the trust, extending beyond any life in being at the date of creation of the trust plus a period of 21 years.

Section 2041(a)(1) provides that the gross estate includes the value of any property with respect to which a general power of appointment created on or before October 21, 1942 is exercised by the decedent by will. However, under section 2041(a)(1)(i), if a general power of appointment created on or before October 21, 1942, is partially released so that it is not thereafter a general power of appointment, a subsequent exercise of the partially released power is not an exercise of a general power of appointment, if the partial release occurs before November 1, 1951.

Section 2041(b) defines a general power of appointment as a power exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate.

Under State law, a power of appointment is not a general power of appointment, unless the donor employs language specifically authorizing the donee to appoint property to his estate or creditors. See Citation 1; Rev. Rul. 1.

In this case, Trusts 1, 2, 3 and 4 were created prior to September 25, 1985, and were all irrevocable prior to that date. Further, it is represented that there have been no additions, either actual or constructive to Trusts 1, 2, 3, or 4, after September 25, 1985. Son partially released his power of appointment over Trust 1 prior to November 1, 1951, retaining a testamentary special power to appoint the trust. In accordance with section 2041(a)(1), the Trust 1 corpus subject to this power will not be included in Son's gross estate for estate tax purposes, whether or not Son exercises the power. Furthermore, as noted above, with respect to Son's testamentary powers of appointment over Trusts 2, 3, and 4, because there is no language in the trust instruments specifically

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authorizing Son to appoint the property to his estate or his creditors, under applicable State law, Son can not exercise the powers in favor of his estate or his creditors. Therefore, the powers are not general powers as defined in section 2041(b), and the property subject to these powers will not be included in Son's gross estate. Rev. Rul. 1. Accordingly, we conclude that Trusts 1, 2, 3, and 4 were irrevocable prior to September 25, 1985 and are currently exempt from GST tax. Further, under section 26.2601-1(b)(1)(i) and (v), whether or not Son exercises the powers over Trusts 1, 2, 3, or 4, the property passing pursuant to a lapse or exercise of these powers will not be considered generation-skipping transfers occurring after September 25, 1985, or post-September 25, 1985 additions to the trusts.

Rulings 3, 4, and 5

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 GST tax under section 26.2601-1(b) 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 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 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. A modification that is administrative in nature that only indirectly increases the amount transferred will not be considered to shift a beneficial interest in the trust.

Section 26.2601-1(b)(4)(E), Example 8, considers 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

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subject the trust to the provisions of chapter 13.

Section 26.2601-1(b)(4)(i)(E), Example 10, considers a situation where a trust is modified by decreasing the number of trustees. The modification pertains to the administration of the trust and does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification. 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.

State Law 2 specifies a number of investments that may be made by a trustee. State Law 2 specifies that the list is not to be construed to make unlawful any investment not listed.

State Law 3 provides generally that a trustee shall allocate to income money received from an entity. The term "entity" includes a limited liability company.

In this case, the trustee is given broad investment powers over Trusts 1, 2, 3, and 4 under the terms of the trusts and under State law.

Accordingly, based on the facts submitted and representations made, we conclude that the proposed investment of substantially all of the assets of the trusts in the LLC as proposed will not cause the trusts to lose GST tax exempt status. Furthermore, the proposed transaction will not cause any portion of any of the trusts to be treated as an addition to the trusts after September 25, 1985.

In addition, the modification of Trust 1 regarding payment of a corporate trustee's fees in accordance with the trustee's published rate schedule, is a modification that is administrative in nature. This modification does not shift any beneficial interest in Trust 1 to any beneficiary who occupies a generation lower than the persons holding the beneficial interests. Further, the proposed modification will not extend the time for vesting of any beneficial interest in the trusts beyond the period provided for in Trust 1. Accordingly, based on the facts submitted and representations made, we conclude that the change to Trust 1 regarding the corporate trustee's fees will not cause Trust 1 to lose its exempt 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.

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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(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,

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