

## Internal Revenue Service

## Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:B04-PLR-112564-02

Date:

FEBRUARY 20, 2003

Re:

### LEGEND:

Settlor	=
Decedent	=
Trust 1	=
Trust 2	=
Trust 3	=
Marital Trust	=
Spouse	=
Son	=
Daughter	=
State X	=
State Statute 1	=
State Statute 2	=
State Statute 3	=
State Statute 4	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
<u>a</u>	=
<u>b</u>	=
Distributing	=
Controlled	=
Subsidiary	=
business <u>m</u>	=
business <u>n</u>	=

Dear :

This is in response to your November 19, 2001 letter and other correspondence requesting rulings concerning the generation-skipping transfer tax consequences of the proposed transactions.

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You have requested the following rulings:

1. The proposed exercise by Spouse of her testamentary special powers of appointment over Trust 1 and Trust 2 will not constitute a constructive addition to either trust.
2. The proposed exercise by Spouse of her testamentary special powers of appointment over Trust 1 and Trust 2 will not cause either trust to lose its exempt status for generation-skipping transfer tax purposes.
3. The trust for the benefit of Son, his spouse, and his issue and the trust for the benefit of Daughter, her spouse, and her issue to be held pursuant to Spouse's proposed exercise of her testamentary special powers of appointment over Trust 1 and Trust 2 will continue to be exempt from the generation-skipping transfer tax.
4. The proposed actions of the trustees of Trust 1 and Trust 2 in executing the Shareholder Voting Agreement on behalf of Trust 1 and Trust 2 will not cause either Trust 1 or Trust 2 (or the trust for the benefit of Son, his spouse, and his issue and the trust for the benefit of Daughter, her spouse, and her issue) to lose their generation-skipping transfer tax exempt status.

The facts submitted are as follows:

On Date 1, Settlor, the father of Decedent, executed his will. Article III(3) of Settlor's will provides that an a% interest of Distributing, a State X corporation, be transferred to Trust 1, a trust to benefit Decedent, his spouse, and his children.

Article VI(2) provides that if Decedent survives Settlor, Decedent shall have a special testamentary power to appoint all property, including principal and accumulated income, remaining in Trust 1 at the time of his death to a class composed of his spouse, his descendants, and the spouses of his descendants. The appointment may be outright or in trust. No appointment shall permit the distribution of property of Trust 1 or the income therefrom to, or for the benefit of, Decedent's estate, Decedent's creditors, and the creditors of Decedent's estate. Further, any trust created in the exercise of Decedent's special testamentary power of appointment shall not extend beyond twenty years and eleven months after the death of the last survivor of Decedent's descendants living at the time of Settlor's death. Settlor died on Date 2 (prior to September 25, 1985).

On Date 3, Decedent executed his will. Article IV of Decedent's will provides that if Spouse, Decedent's wife, survives Decedent, fifty percent of Decedent's adjusted gross estate, as finally determined for federal estate tax purposes, less the aggregate of all other items of Decedent's gross estate which pass or have passed to Spouse or

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to Marital Trust (whether passing under the will or otherwise) shall constitute Marital Trust. Only assets which qualify for the marital deduction shall pass to Marital Trust. During Spouse's lifetime, the trustees shall distribute to Spouse, all the net income and so much of the principal as the trustees deem necessary to provide for Spouse's health, support, care, and comfort. Spouse shall have a general testamentary power to appoint the entire corpus of Marital Trust.

Article V provides that upon Decedent's death, all property that remains after satisfaction of unexpired devises and bequests contained in Articles III and IV shall constitute Trust 2 for the benefit of Spouse, if she survives Decedent, and Decedent's issue.

Article V(2) provides that if Spouse survives Decedent, she shall have a special testamentary power to appoint all property, including principal and accumulated income, remaining in Trust 2 at the time of her death to or among a class composed of Decedent's issue and the spouses of Decedent's issue. The appointment may be outright or in trust. No appointment shall permit the distribution of property of Trust 2 or the income therefrom to, or for the benefit of, Spouse's estate, Spouse's creditors, and the creditors of Spouse's estate. Further, any trust created in the exercise of Spouse's special testamentary power of appointment shall not extend beyond twenty years and eleven months after the death of the last survivor of Spouse and Decedent's descendants living at the time of Decedent's death.

In Article XIV, Decedent exercises the special power of appointment granted to him by Settlor. The will provides that the assets of Trust 1 shall continue to be held in a trust which is in all respects identical to the terms of Trust 2. The terms of Decedent's will which relate to Trust 2 are incorporated by reference into Trust 1, provided, if not sooner terminated, Trust 1 shall terminate not later than twenty years and eleven months after the death of the last survivor of Decedent's issue who was living at the date of Settlor's death.

Decedent died on Date 4 (prior to September 25, 1985). The trustees represent that no additions were made to Trust 1 or Trust 2 after September 25, 1985. Spouse, Son, and Daughter were living as of the date of Settlor's death.

Distributing is currently engaged directly in business m. Distributing also owns a greater than 90% interest in Subsidiary, which is engaged in business n. Trust 1, Trust 2, Son, Son's spouse, Daughter, Daughter's spouse, and Trust 3, a trust for the benefit of Spouse, are the sole shareholders of Distributing.

In order to enhance the success of business m and business n and enable Son and his family to control business n and Daughter and her family to control business m, the shareholders of Distributing propose to separate these businesses and place them under the directed ownership and control of each family.

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Accordingly, Distributing will form Controlled, a new wholly-owned subsidiary, by contributing all of its assets related to business m to Controlled in exchange for all the stock of Controlled and Controlled's assumption of all the liabilities associated with business m, plus the liabilities to which such transferred assets are subject. Daughter and her spouse will surrender their stock in Distributing for stock in Controlled. Son and his spouse will retain their stock in Distributing. Trust 1, Trust 2, and Trust 3 will surrender half of their Distributing stock for Controlled stock. After these distributions, Distributing will no longer hold any Controlled stock. Controlled will take the name formerly used by Distributing, and Distributing will surrender such name and assume a new name, yet to be determined, reflecting its business n operation. The reason for the change is that Distributing's former name has always been associated with the business m operations and the parties to the transaction desire to maintain such tradition.

Following these distributions, Daughter and her spouse will hold stock in Controlled and Son and his spouse will hold stock in Distributing. Trust 1, Trust 2, and Trust 3 will continue to hold stock in Distributing and Controlled. Accordingly, the shareholders of Distributing and Controlled entered into the Shareholder Voting Agreement in which the trustees of each trust delegate by irrevocable proxy to Son the power to vote the stock of Distributing and delegate by irrevocable proxy to Daughter the power to vote the stock of Controlled. The trustees of Trust 1 and Trust 2 represent that the Shareholder Voting Agreement will not modify or change the trustees' sole authority to make distributions from Trust 1 and Trust 2 to the beneficiaries of both trusts. Except as directed by the Shareholder Voting Agreement, the trustees will continue to serve in the same manner as they have previously served.

Further, Spouse will exercise her special testamentary power of appointment over Trust 1 and Trust 2 and her general testamentary power of appointment over Marital Trust by executing a codicil to her will. The proposed exercise will provide that upon her death, Trust 1, Trust 2, and Marital Trust will each be divided into two shares. One share of Trust 1, Trust 2, and Marital Trust will be appointed in trust for the benefit of Son, his spouse, and his issue. The other share of Trust 1, Trust 2, and Marital Trust will be appointed in trust for the benefit of Daughter, her spouse, and her issue. All of the Distributing stock held by Trust 1, Trust 2, and Marital Trust will be allocated to the trust shares held under the trust for the benefit of Son, his spouse, and his issue. All of the Controlled stock held by Trust 1, Trust 2, and Marital Trust will be allocated to the trust shares held under the trust for the benefit of Daughter, her spouse, and her issue.

The shares for the benefit of Son, his spouse, and his issue, will be held in trust until the death of the survivor of Son and his spouse. The trustees will have discretion to distribute so much of the income and principal of the trust as is necessary to provide for the health, support, maintenance, and education, of Son, his spouse, and his issue. Upon the death of the survivor of Son and his spouse, the trustee will divide and distribute outright all remaining assets of the trust to Son's then living issue, per stirpes.

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The terms are identical for the trust shares held for the benefit of Daughter, her spouse, and her issue.

Notwithstanding anything to the contrary, all the property of Trust 1 shares appointed by Spouse to the trust to benefit Son, his spouse, and his issue and the trust to benefit Daughter, her spouse, and her issue shall be finally distributed not later than twenty (20) years and eleven (11) months after the date of the death of the last survivor of the issue of Decedent who were living at the date of the death of Settlor, and if at the expiration of such period any part of the trust remains undistributed, the same immediately shall vest in, and be distributed unto to persons then living to whom, and in the proportions in which, distribution would have been made had the date for final distribution thereof arrived.

Notwithstanding anything to the contrary, all the property of Trust 2 and the Marital Trust shares appointed by Spouse to the trust to benefit Son, his spouse, and his issue and the trust to benefit Daughter, her spouse, and her issue shall be finally distributed not later than twenty (20) years and eleven (11) months after the date of the death of the last survivor of Spouse and the issue of Decedent who were living at the date of the death of Decedent, and if at the expiration of such period any part of the trusts remain undistributed, the same immediately shall vest in, and be distributed unto the persons then living to whom, and in the proportions in which, distribution would have been made had the date for final distribution thereof arrived.

State Statute 1 provides that from the time of creation of a trust until final distribution of assets of the trust, a trustee has the power to perform, without court authorization, every act which a prudent person would perform for the purposes of the trust including, but not limited to, the powers specified in State Statutes 2 and 3.

State Statute 2 provides that a trustee has the power to continue, participate in, or enter into the operation of any business or other enterprise, including, but not limited to, general partnerships, limited partnerships, joint ventures, and other unincorporated associations, and to effect incorporation, dissolution, or other change in the form of the organization.

State Statute 3 provides that a trustee has the power to execute and deliver all instruments which will accomplish or facilitate the exercise of the powers vested in the trustee.

State Statute 4 provides that except as specifically provided in the trust instrument, State Statutes 1-3 shall apply to any trust established and to any trust asset acquired by the trustee before or after the effective date of State Statutes 1-3.

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## LAW AND ANALYSIS

Section 2041(a)(2) provides, in part, that the value of the gross estate shall include the value of all property to the extent of any property with respect to which the decedent has at the time of his death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under sections 2035 to 2038, inclusive.

Section 2041(b)(1) provides that the term "general power of appointment" means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate.

Section 2601 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 generation-skipping transfer (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 any generation-skipping transfer under a trust that was irrevocable on September 25, 1985, and no addition (actual or constructive) was made to the trust after that date. 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 under chapter 11 or chapter 12. The transfer is made by the person holding the power at the time the exercise, release, or lapse of the power becomes effective, and is not considered a transfer under a trust that was irrevocable on September 25, 1985.

Under section 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 section 2038 or 2042, if the settlor had died on September 25, 1985.

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 reason of section 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. If an addition is made, the trust is thereafter deemed to consist of two portions, a portion not subject to chapter 13 (the non-chapter 13 portion) and a portion subject to chapter 13 (the chapter 13 portion), each with a separate inclusion ratio (as defined in section

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2642(a)). For purposes of chapter 13, a constructive addition under section 26.2601-1(b)(1)(v) is treated as an addition.

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 under chapter 11 or chapter 12, 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. The creator of the power will be considered the transferor of the addition except to the extent that the release, exercise, or lapse of the power is treated as a taxable transfer under chapter 11 or chapter 12.

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 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)(A) provides that the distribution of trust principal from an exempt trust to a new trust or retention of trust principal in a continuing trust will not cause the new or continuing trust to be subject to the generation-skipping transfer tax if -- (1) either -- (i) the terms of the governing instrument of the exempt trust authorize distributions to the new trust or the retention of trust principal in a continuing trust, without the consent or approval of any beneficiary or court; or (ii) at the time the exempt trust became irrevocable, state law authorized distributions to the new trust or retention of principal in the continuing trust, without the consent or approval of any beneficiary or court; and (2) the terms of the governing instrument of the new or continuing trust do not extend the time for vesting of any beneficial interest in the trust 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 the original trust became irrevocable, extending beyond any life in being at the date the original trust became

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irrevocable plus a period of 21 years, plus if necessary, a reasonable period of gestation.

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 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. 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.

In this case, Spouse's special powers of appointment were created in Trust 1 and Trust 2, irrevocable trusts not subject to chapter 13 under section 26.2601-1(b)(1). The proposed exercise of Spouse's testamentary powers of appointment will not 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 trusts, extending beyond any life in being at the date of creation of the trusts plus a period of 21 years. Accordingly, we conclude that the proposed exercise by Spouse of her testamentary special powers of appointment over Trust 1 and Trust 2 will not constitute a constructive addition to either trust and will not cause Trust 1 or Trust 2 to lose their GST exempt status. The portion of the trust for the benefit of Son, his spouse, and his issue and the portion of trust for the benefit of Daughter, her spouse, and her issue comprised of property appointed by Spouse from Trust 1 and Trust 2 will continue to be exempt from GST tax.

The proposed actions of the trustees of Trust 1 and Trust 2 in executing the Shareholder Voting Agreement on behalf of Trust 1 and Trust 2 are administrative actions. Accordingly, based on the facts submitted and the representations made, we conclude that the proposed actions of the Trustees of Trust 1 and Trust 2 in executing the Shareholder Voting Agreement on behalf of Trust 1 and Trust 2 will not cause either Trust 1 or Trust 2 (or the trust for the benefit of Son, his spouse, and his issue and the trust for the benefit of Daughter, her spouse, and her issue) to lose their exempt status for GST purposes.

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



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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.

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,

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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