

## 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 - 100441-03

Date:

July 30, 2003

Re:

### Legend

Father =

Mother =

Trust =

Trustees =

LLC =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

Trust 1 =

Trust 2 =

Trust 3 =

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Trust 4 =

Son 1 =

Son 2 =

Son 3 =

Son 4 =

State 1 =

State 1 Court =

State 2 =

State 2 Court =

X =Y =Z =

State 2 Statute 1 -

State 2 Statute 2 -

Dear :

This is in response to the December 26, 2002, letter submitted by your authorized representative on your behalf, and subsequent correspondence, concerning the generation-skipping transfer (GST) tax status of Trusts 1-3.

The facts and representations submitted are summarized as follows: Father died testate on Date 1 prior to September 25, 1985. Under Article Second of his will, dated Date 2, Father created Trust for the lifetime benefit of his wife, Mother. Article Second of Father's will also granted Mother a limited testamentary power of appointment over Trust.

Mother died testate on Date 3, also prior to September 25, 1985. Under Article Sixth of her will, dated Date 4, Mother exercised the limited testamentary power of appointment over Trust by dividing Trust into four equal "portions", with each separate portion to be held for the benefit of Son 1, Son 2, Son 3, and Son 4, respectively, and their families. Each portion is to be held for the benefit of each son, his wife or widow, and his issue until the later of the death of the son or the death of his widow. Income is to be paid to "such person or persons belonging to a class composed of the son for whom such portion is named and the wife, widow and issue of such son" in the trustees' absolute discretion. Upon the death of each son or the death of his widow, the son's portion is to be paid to the son's issue in equal shares "per stirpes".

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Article Seventh of Mother's will provides, in part, that the trustees shall have the power, authority and discretion:

to sell convey and exchange at such times and on such terms and conditions as to credit or otherwise, and in such manner as they may think proper, any and all stocks, bonds, mortgages, mortgage certificates, voting trust certificates, and other personal property of said trust fund, and to reinvest the proceeds of sale, and any other funds which may come into their hands as trustees, in such stocks, bonds, mortgages, mortgage certificates, voting trust certificates and other property as they may think proper, whether or not such investments are authorized by law as proper investments for trust funds. . .

Son 4 survived his wife and died on Date 5. Accordingly, Son 4's portion was distributed outright to Son 4's issue. The portions established for Son 1-3 are still in existence. Trustees are currently serving as the co-trustees.

Through 2001, a single federal income tax return was filed for Trust. The Trustees subsequently determined that the 3 portions should have been treated for all purposes as separate trusts.

The original situs of Trust was State 1. On or about Date 6, Trustees agreed to secure office space in State 2, for the purpose of conducting operations and administration. Trustees have filed a complaint in State 2 Court, and received an order from State 2 Court on Date 7 providing the following declaratory relief: (1) State 2 Court has jurisdiction over Trusts 1-3; (2) Trusts 1-3 are separate and distinct trusts designated as Trust 1, Trust 2, and Trust 3; (3) the terms of Trusts 1-3 do not violate State 2 law; (4) State 2 conflicts of laws rules call for the continued application of State 1 law to matters of construction of the terms of Trusts 1-3; (5) the change of situs of Trusts 1-3 does not violate State 2 law; (6) the situs of Trusts 1-3 is State 2; and (7) State 2 law will apply to questions of administration of Trusts 1-3.

On Date 8, Trustees petitioned State 1 Court to order that the situs of Trusts 1-3 be moved from State 1 to State 2.

Trust was irrevocable on September 25, 1985. It is represented that no actual or constructive additions have been made to Trust or to Trusts 1-3 after that date.

On Date 9, Trustees established LLC, a State 2 limited liability company. Trusts 1-3 are the sole members of LLC and Trustees are the managers of LLC. Trusts 1-3 contributed substantially all of each trust's assets to LLC as capital contributions, and each trust received an identical interest in LLC. It is represented that Trustees are permitted to invest trust assets in LLC by virtue of their broad investment authority, as

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provided in Trusts 1-3 and State 2 law and, therefore, the Trustees did not request court approval with respect to the investment in LLC.

Article 7.5.a. of the LLC Operating Agreement provides, in part, that each year, the managers shall distribute cash to the equity interest owners (Trusts 1-3) in proportion to their respective membership interests in an amount equal to the greater of: (i) x percent of the fair market value of the LLC's assets; or (ii) the net income of the LLC, calculated in accordance with the State 2 Uniform Principal and Income Act and determined as if the LLC were a trust. Additional distributions of cash or other property are permitted, provided that, in any one year, the managers shall not make additional distributions of cash to the Trusts if such cash distributions would be treated as income under the State 2 Uniform Principal and Income Act. Additionally, the managers may distribute cash to each member in an amount equal to such member's capital gain taxes attributable to capital gain realized by the LLC.

However, Article 7.5.d. of the LLC Operating Agreement provides as follows:

[T]he trustees of [Trust 1-3] may only make distributions in excess of the net income of the [LLC], calculated in accordance with the [State 2] Uniform Principal and Income Act and determined as if the [LLC] were a trust, to the son of [Father] and [Mother] for whom the trust was named, his wife, his widow and those issue of the son who would receive a share of the trust property if the survivor of the son of [Father] and [Mother] for whom the trust was named and his widow were to die on the date of the distribution and the remainder were to be distributed to the issue of such son in equal shares, per stirpes and not per capita.

Article 7.5.b. of the LLC Operating Agreement provides, in part, that distributions of cash or other property shall be made to the equity interest owners in proportion to their respective membership interests. Managers have the discretion, subject to the manager's fiduciary duty, to determine whether cash or other property shall be distributed and the timing of such distributions.

Article 8.3 of the LLC Operating Agreement provides that each member of the LLC "may withdraw, cumulatively, during each five year period from time to time up to \$y of such member's membership interest in the [LLC], provided, however, that the minimum amount that may be withdrawn at any one time shall be \$z," and that the value of the member's interest in the LLC is greater than the requested withdrawal amount. To the extent that the withdrawal made under Article 8.3 is not treated as a distribution of principal under State 2 Uniform Principal and Income Act, such distribution shall be made in kind and not in cash.

You have requested the following ruling requests:

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- (1) Trusts 1-3 are wholly exempt from the GST tax under section 1433(b)(2)(A) of the Tax Reform Act of 1986;
- (2) The change of the situs from State 1 to State 2 will not cause Trusts 1-3 to lose their exempt status;
- (3) The ruling of State 2 Court confirming that there are three separate and distinct trusts will not cause Trusts 1-3 to lose their GST exempt status;
- (4) The Trustees' proposed investment of substantially all of the assets of Trusts 1-3 in LLC will not cause Trusts 1-3 to lose their exempt status because the proposed investment will not shift a beneficial interest in any of the Trusts; and
- (5) The Trustees' proposed investment of substantially all of the assets of Trusts 1-3 in LLC will not cause any portion of any of the Trusts to be treated as if it had been added to the Trusts after September 25, 1985.

### Ruling 1

Section 2601 imposes a tax on each generation-skipping transfer made by a "transferor" to a "skip person" with respect to the transferor of the property. Under section 2652(a)(1), the transferor of the property for GST tax purposes is the last person with respect to whom the property was subject to estate or gift tax.

Under section 1433(a) of the Tax Reform Act of 1986, the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under section 1433(b)(2)(A) of the Tax Reform Act and section 26.2601-1(b)(1)(i) of the 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. See section 26.2601-1(b)(1)(v) regarding constructive addition.

In this case, Trust was established prior to September 25, 1985 and the separate portions that became Trusts 1-3 were established pursuant to Mother's exercise of a testamentary limited power of appointment, effective on Date 3, Mother's date of death, also prior to September 25, 1985. It is represented that there have been no additions, either actual or constructive, to Trusts 1-3 after September 25, 1985. Accordingly, we conclude that Trusts 1-3 are exempt from GST tax under section 1433(b)(2)(A) of the Tax Reform Act of 1986.

### Rulings 2 - 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 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)(i)(E), Example 4, involves a trust that is irrevocable on or before September 25, 1985. In 1980, Grantor, who was domiciled in State X, executed an irrevocable trust for the benefit of Grantor's issue, naming a State X bank as trustee. Under the terms of the trust, the trust is to terminate, in all events, no later than 21 years after the death of the last to die of certain designated individuals living at the time the trust was executed. In 2002, State Y bank replaced State X bank as sole trustee. The effect of changing trustees is that the situs of the trust changes to State Y, and the laws of State Y govern the administration and construction of the trust. State Y law contains no rule against perpetuities. In view of the terms of the trust instrument, the trust will terminate at the same time before and after the change in situs. Accordingly, the change in situs does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficiary interest prior to the transfer. Furthermore, the change in situs does not extend the time for vesting of any beneficial interest in the trust beyond that provided for in the original trust. Therefore, the trust will not be subject to the provisions of chapter 13.

Section 26.2601-1(b)(4)(i)(E), Example 5, involves a trust that is irrevocable on or before September 25, 1985. The trustee has the discretion to distribute income and principal to A, B, and their issue in such amounts as the trustee deems appropriate. On the death of the last to die of A and B, the trust principal is to be distributed to the living issue of A and B, per stirpes. In 2002, the appropriate local court approved the division of the trust into two equal trusts, one for the benefit of A and A's issue and one for the benefit of B and B's issue. The trust terms are identical except for the beneficiaries. The division of the trust into two trusts does not shift any beneficial interest in the trust 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 division. In addition, the division 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 two partitioned trusts resulting from the division will not be subject to the provisions of chapter 13.

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

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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 trust will not be subject to the provisions of chapter 13.

State 2 Statute 1 provides that a fiduciary may "acquire and retain every kind of property, real, personal or mixed, and every kind of investment. . . which persons of prudence, discretion and intelligence acquire or retain for their own account."

State 2 Statute 2 provides that "a trustee shall allocate to income money received from an entity." State 2 Statute 2 further provides that an "entity" includes a limited liability corporation.

In this case, the court order confirming that the separate portions that became Trusts 1-3 are separate trusts, and the change of situs of Trusts 1-3, will not result in a shift of any beneficial interest in the Trusts to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the division or change in situs. Further, the division and change in situs will not extend the time for vesting of any beneficial interest in the Trusts beyond the period provided for in the original trust. Accordingly, based on the facts submitted and the representations made, we conclude that the court order confirming that the separate portions that became Trusts 1-3 are separate trusts, one trust for the benefit of Son 1 and his family (Trust 1), one trust for the benefit of Son 2 and his family (Trust 2), and one trust for the benefit of Son 3 and his family (Trust 3), and the change of situs from State 1 to State 2 will not cause Trusts 1-3 to lose exempt status for GST tax purposes under section 2601.

In addition, we conclude that the investment of substantially all of the assets of Trusts 1-3 in LLC, as described above, will not shift any beneficial interests in Trust 1-3 to lower generation beneficiaries and the investment will not cause any portion of any of the trusts to be treated as an addition to Trusts 1-3 after September 25, 1985. Accordingly, the investment of substantially all of the assets of Trusts 1-3 in LLC will not cause the trusts to lose GST tax exempt status.

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

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referenced in this letter. This ruling is directed only to the taxpayers requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

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

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

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

Enclosures

Copy for section 6110 purposes  
Copy of this letter