

Internal Revenue Service

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Department of the Treasury

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Third Party Communication: None

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PLR-142018-05

Date: MAY 12, 2006

Legend

H =

W =

Trust 1 =

Trust 2 =

Trust 3 =

Date 1 =

Date 2 =

Grandchild 1 =

Grandchild 2 =

Grandchild 3 =

Year 1 =

Year 4 =

Year 5 =

Year 8 =

Dear :

This is in response to your letter dated August 5, 2005, submitted on your behalf by your authorized representative, and other correspondence, regarding the gift tax and generation-skipping transfer (GST) tax consequences of certain transfers to Trusts 1-3.

The facts and representations submitted are summarized as follows: On Date 1, H and W established two separate irrevocable trusts, Trust 1 and Trust 2, for the benefit of Grandchild 1 and Grandchild 2, respectively. On Date 2, H and W established a third irrevocable trust, Trust 3, for the benefit of Grandchild 3. The terms of Trusts 1-3 are substantially identical but for the identity of the grandchild for whom the Trust was established (the primary beneficiary).

Under the terms of each Trust, the trustee may distribute any part or all of the income and principal of the trust to or for the benefit of the primary beneficiary during the primary beneficiary's lifetime. If the primary beneficiary is not living, then to the extent the trust corpus is not appointed by the primary beneficiary, as discussed below, the trustee may distribute any part or all of the income and corpus to the primary beneficiary's descendants, or if none, then to the primary beneficiary's siblings and their descendants, or if none, then to other beneficiaries who may include non-skip persons, as defined in § 2613(b). Each trust provides that the trustee is to make distributions "as the trustee shall deem to be in the best interest of the beneficiary or beneficiaries; Grantor does not intend that such distributions be limited to the amounts necessary for maintenance, education, and support."

With respect to Trusts 1 and 2, if the primary beneficiary dies prior to reaching age 21, the corpus is to be distributed pursuant to the primary beneficiary's exercise of a testamentary general power to appoint the accumulated income and corpus of Trust to certain person's and entities including the primary beneficiary's estate. With respect to Trust 3, if the primary beneficiary dies prior to reaching age 21, the primary beneficiary may, with the consent of a trustee who is not an adverse party, by written instrument delivered to the trustee, appoint the accumulated income and corpus of Trust 3 to the primary beneficiary's estate. A trustee who is "not an adverse party" is defined in Trust 3 as a trustee who is a person not having a substantial interest in the trust estate which is adverse to the exercise of the power in favor of the primary beneficiary. If there is no such trustee then acting, Trust 3 provides a procedure for designating such trustee.

Upon reaching age 21, the primary beneficiary has the right to terminate their respective Trust. If the primary beneficiary exercises this right, the trust assets will be distributed to the primary beneficiary in fee simple and free of trust. If the primary beneficiary does not exercise this right within 60 days after receiving notice, the right to terminate will lapse.

If the primary beneficiary does not exercise the termination power, then each Trust continues after the primary beneficiary reaches age 21. The trustee's authority to

make discretionary distributions to the primary beneficiary continues, as described above. Upon the primary beneficiary's death, the trust corpus is to be distributed pursuant to the primary beneficiary's exercise of a testamentary special power to appoint Trust income and corpus to H and W's descendants.

After the primary beneficiary reaches age 21, any person may make a contribution to the Trust and grant to any of H's and W's descendants the right to withdraw property from the Trust equal to the lesser of: (1) the greater of \$5,000 or 5% of the aggregate value of the trust principal, or (2) the beneficiary's proportionate share of the contribution (based on the number of beneficiaries with withdrawal rights). This right will lapse if it is not exercised within 60 days after the beneficiary receives notice of the contribution.

The trustee is directed to segregate any part of the trust property to which GST exemption was allocated (the exempt portion). Any exempt portion shall be held by the trustee as a separate trust with the same terms, conditions, and name as the trust from which it was segregated provided that the exempt portion shall have a zero inclusion ratio as defined in § 2642.

All trusts created under the trust agreement will terminate on the day preceding the expiration of 21 years from the death of the last survivor of the following persons living on the date of Trust is executed: (1) H and W; (2) H's and W's children and other descendants of H and W; and (3) all persons who are mentioned by name in the trust agreement and all of their descendants. Upon termination, the assets of Trust will be delivered and distributed in fee simple and free of trust to the income beneficiaries at the time of termination.

It is represented that H and W made transfers of cash to Trusts 1 and 2 in Years 1-5, and to Trust 3 in Years 4-8. In each case, the transfer made in a calendar year to each trust did not exceed the gift tax annual exclusion for that year under § 2503(b). Grandchild 1, 2, and 3 are all currently under the age of 21.

The following rulings have been requested:

(1) Each of Trusts 1-3 satisfies the requirements of § 2503(c) from the date of its inception through the date the primary beneficiary reaches age 21 (the "contribution period"). Accordingly, all contributions to Trusts 1 and 2 in Years 1-5 and to Trust 3 in Years 4-8, were excluded from H's and W's total gifts for federal gift tax purposes. Further, all future contributions to each of Trusts 1-3 during the contribution period will be excluded from H's and W's total gifts for federal gift tax purposes, except to the extent any contributions exceed the amount described in § 2503(b).

(2) Each of Trusts 1-3 is a "skip person" with respect to H and W (within the meaning of § 2613(a)) during the contribution period. Accordingly, all contributions by H and W to Trusts 1-2 in Years 1-5 and to Trust 3 in Years 4-8, were "direct skips" (within

the meaning of § 2612(c)), and any further contributions by H and W to Trusts 1-3 during this period will be “direct skips”.

(3) H's and W's unused GST exemption was automatically allocated to contributions by H and W to Trusts 1 and 2 in Years 1-5 and Trust 3 in Years 4-8 to the extent necessary to make the inclusion ratio for such property zero, in accordance with § 2632(b)(1).

Section 2501(a) imposes a tax on the transfer of property by gift during each calendar year by any individual.

Section 2511 provides that the gift tax imposed by § 2501 applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2503(b) provides that in the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the first \$10,000 (adjusted for inflation as provided in § 2503(b)(2)) of such gifts to such person shall not be included in the total amount of gifts made during such year.

Section 25.2503-3(a) of the Gift Tax Regulations provides that no part of the value of a gift of a future interest may be excluded in determining the total amount of gifts made during the calendar period. "Future interest" is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time. Section 25.2503-3(b) provides that an unrestricted right to the immediate use, possession or enjoyment of property or the income from property (such as a life estate or term certain) is a present interest in property. An exclusion is allowable with respect to a gift of such an interest.

Section 2503(c) provides that no part of a gift to an individual who has not attained the age of 21 years on the date of the transfer shall be considered a gift of a future interest in property for purposes of § 2503(b) if the property and the income therefrom may be expended by, or for the benefit of, the donee before his attaining the age 21 years and will to the extent not so expended pass to the donee on his attaining the age of 21 years, and in the event the donee dies before attaining the age of 21 years, be payable to the estate of the donee or as he may appoint under a general power of appointment as defined in § 2514(c).

Section 25.2503-4(b) provides, in part, that a transfer does not fail to satisfy § 2503(c) by reason of the mere fact that: (1) there is left to the discretion of a trustee the determination of the amounts, if any, of the income or property to be expended for the benefit of the minor and the purpose for which the expenditure is to be made, provided there are no substantial restrictions under the terms of the trust instrument on

the exercise of such discretion; (2) the donee, upon reaching age 21, has the right to extend the term of the trust; or (3) the governing instrument contains a disposition of the property or income not expended during the donee's minority to persons other than the donee's estate, in the event of the default of appointment by the donee.

Revenue Ruling 74-43, 1974-1 C.B. 285, holds that a gift in trust for the benefit of a minor beneficiary satisfies the requirements of § 2503(c), where the trust provides that the beneficiary has, upon reaching age 21, either (1) a continuing right to compel immediate distribution of the trust corpus by giving written notice to the trustee, or to permit the trust to continue by its own terms, or (2) a right during a limited period to compel immediate distribution of the trust corpus to the beneficiary, which if not exercised will permit the trust to continue by its own terms. Accordingly a transfer to the trust will constitute a gift of a present interest qualifying for the annual exclusion under § 2503(b).

Section 2514(b) provides that the exercise or release of a general power of appointment created after October 21, 1942, shall be deemed a transfer of property with respect to the individual possessing the power.

Section 2514(c) defines "general power of appointment" as a power exercisable in favor of the individual possessing the power, the individual's estate, or the creditors of either. In general, under § 2514(c)(3), a power exercisable by the possessor in conjunction with another person is a general power of appointment if the person whose joinder is required does not have a substantial interest in the property subject to the power which is adverse to the exercise of the power in favor of the decedent.

Section 2514(e) provides that the lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power. However, this rule applies with respect to the lapse of powers during any calendar year only to the extent that the property, which could have been appointed by exercise of such lapsed powers, exceeded in value, at the time of such lapse, the greater of the following amounts: (A) \$ 5,000, or (B) 5 percent of the aggregate value, at the time of such lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied.

Section 2601 imposes a tax on every generation-skipping transfer (GST). A GST is defined under § 2611(a) as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 2612(c)(1) provides that the term "direct skip" means a transfer subject to a tax imposed by chapter 11 or 12 of an interest in property to a skip person. Section 2613(a) provides that the term "skip person" means a natural person assigned to a generation which is 2 or more generations below the generation assignment of the transferor, or a trust if all "interests" in such trust are held by skip persons.

Under § 2652(c)(1) and § 26.2612-1(e) of the Generation-Skipping Transfer Tax Regulations, a person has an interest in a trust if a person has a present right to receive trust principal or income; is a permissible current recipient of trust principal or income and is not described in § 2055(a); or is described in § 2055(a) and the trust is a charitable remainder annuity trust or unitrust (as defined in § 664(d)) or a pooled income fund (as defined in § 642(c)(5)).

Section 2623 provides that the taxable amount in the case of a direct skip shall be the value of the property received by the transferee.

Section 2602 provides that the amount of the tax is the taxable amount multiplied by the applicable rate. Section 2641(a) defines “applicable rate” as the product of the maximum federal estate tax rate and the inclusion ratio with respect to the transfer.

Under § 2642(a)(1), the inclusion ratio with any property transferred in a generation-skipping transfer is generally defined as the excess of 1 over the “applicable fraction.” The applicable fraction, as defined in § 2642(a)(2), is a fraction, in which the numerator is the amount of GST exemption under § 2631 allocated to the trust (or to property transferred in a direct skip), and the denominator is the value of the property transferred to the trust or involved in the direct skip.

Section 2654(b) provides that for purposes of GST tax the portions of a trust attributable to transfers from different transferors shall be treated as separate trusts, and substantially separate and independent shares of different beneficiaries in a trust shall be treated as separate trusts.

Section 2631(a) as in effect for GST transfers before January 1, 2004, provides that, for purposes of determining the inclusion ratio, every individual shall be allowed a GST exemption of \$1,000,000 (adjusted for inflation under § 2631(c)) which may be allocated by such individual (or his executor) to any property with respect to which such individual is the transferor. For GST transfers after December 31, 2003, the GST exemption amount is equal to the applicable exclusion amount under § 2010. Section 2631(b) provides that any allocation under § 2631(a), once made, shall be irrevocable.

Section 2632(a) provides that any allocation by an individual of his or her GST exemption under § 2631(a) may be made at any time on or before the date prescribed for filing the estate tax return for such individual's estate (determined with regard to extensions), regardless of whether such a return is required to be filed.

Section 2632(b)(1) provides that if any individual makes a direct skip during his lifetime, any unused portion of such individual's GST exemption shall be allocated to the property transferred to the extent necessary to make the inclusion ratio for such property zero. If the amount of the direct skip exceeds such unused portion, the entire unused portion shall be allocated to the property transferred. Section 2632(b)(2) provides that for purposes of § 2632(b)(1), the unused portion of an individual's GST

exemption is that portion of such exemption which has not previously been allocated by such individual (or treated as allocated under § 2632(b)(1) or § 2632(c)(1)).

Section 2642(b)(1) provides, in part, that if the allocation of the GST exemption to any transfers of property is deemed to be made under § 2632(b)(1) or (c)(1), the value of such property for purposes of § 2642(a) shall be its value as finally determined for purposes of chapter 12 (within the meaning of § 2001(f)(2)). Such allocation shall be effective on and after the date of such transfer.

In this case, the terms of Trusts 1-3 provide that the trustee may make discretionary distributions of corpus and income to Grandchild 1, Grandchild 2 or Grandchild 3, respectively, until the beneficiary reaches age 21. If the Grandchild dies before reaching age 21, the corpus is to be distributed pursuant to the Grandchild's exercise of a general power of appointment. Upon reaching age 21, the respective Grandchild has the right to terminate his or her trust and receive the accumulated income and corpus free of trust. However, if the Grandchild does not terminate the trust, then the trust continues for the benefit of the Grandchild.

Based upon the information submitted and the representations made, we conclude as follows:

(1) From the date of its inception through the date the primary beneficiary reaches age 21 (the "contribution period"), each of Trusts 1-3 satisfies the requirements of § 2503(c). Accordingly, H's and W's contributions to Trusts 1 and 2 in Years 1-5 and to Trust 3 in Years 4-8, are excluded from the respective donor's total gifts for federal gift tax purposes. Further, all of H's and W's future contributions to each of Trusts 1-3 during the contribution period will be excluded from the respective donor's total gifts for federal gift tax purposes, except to the extent any contributions exceed the amount described in § 2503(b).

(2) Each of Trusts 1-3 is a "skip person" with respect to H and W (within the meaning of § 2613(a)) during the contribution period. Accordingly, all contributions by H and W to Trusts 1 and 2 in Years 1-5 and to Trust 3 in Years 4-8, were "direct skips" (within the meaning of § 2612(c)), and any further contributions by H and W to Trusts 1-3 during this period will be "direct skips".

(3) In accordance with § 2632(b)(1), H's and W's unused GST exemption was automatically allocated to contributions by H and W to Trusts 1 and 2 in Years 1-5 and Trust 3 in Years 4-8 to the extent necessary to make the inclusion ratio for such property zero.

Except as specifically ruled herein, we express or imply no opinion on the federal tax consequences of any aspect of any transaction or item discussed or referenced in this letter under the cited provisions or under any other provisions of the Code. No opinion is expressed or implied concerning the application of § 2642(c)(2) to Trusts 1-3.

The rulings contained in this letter are based upon information and representations submitted by the taxpayers 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.

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

Sincerely,

George L. Masnik
Branch Chief, Branch 4
(Passthroughs & Special Industries)

Enclosures

Copy for section 6110 purposes
Copy of this letter

cc: