

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:4-PLR-105342-02

Date:

DECEMBER 04, 2002

Re:

LEGEND:

- Grandparents =
- Child A =
- Child B =
- Grandchild A =
- Grandchild B =
- Grandchild C =
- Trust =
- Grandchild A Trust =
- Grandchild B Trust =
- Grandchild C Trust =
- Corporate Trustee =
- Date 1 =
- Date 2 =
- Date 3 =
- Court =
- First Order =
- Second Order =
- State Statute =

Dear :

This is in response to the August 9, 1999 letter and subsequent correspondence requesting a ruling regarding the generation-skipping transfer tax (GSTT) consequences of a judicial construction of Trust.

Facts

The facts submitted and representations made are as follows. Grandparents

PLR-105342-02

irrevocably created Trust on Date 1, before September 25, 1985, and designated Child A as trustee.

Three Schedules are included as part of Trust, Schedule A, Schedule B, and Schedule C. Grandchild A's name is designated on Schedule A, Grandchild B's name is designated on Schedule B, and Grandchild C's name is designated on Schedule C. Each schedule lists a specified number of corporate shares.

Under Article I, paragraph (a) of Trust, the trustee is to: (i) set apart the property described in each Schedule as a separate fund for the primary benefit of the respective grandchild named on that Schedule; and (ii) administer and dispose of each fund as a separate and distinct trust fund as though created by separate instrument. Pursuant to this directive, the trustee established Grandchild A Trust, Grandchild B Trust, and Grandchild C Trust. It is represented that no additions, actual or constructive, were made to Trust or to Grandchild A Trust, Grandchild B Trust, or Grandchild C Trust after September 25, 1985.

Under Article I, paragraph (c), after a grandchild attains age 21, the trustee is to distribute to him or her so much of the income of the fund held for that grandchild's benefit as the trustee in his absolute discretion deems advisable for the grandchild's comfortable support, education, welfare and happiness. The remaining income is to be added to principal. In addition, the trustee may, if in the trustee's discretion it is deemed advisable, distribute part or all of the principal of a grandchild's fund to that grandchild.

Under Article I, paragraphs (d) and (e), if a grandchild dies before all of the fund held for him or her has been distributed, the grandchild may appoint the fund by will to such of Grandparents' then living lawful descendants and subject to such trusts and conditions as the grandchild directs.

To the extent a grandchild fails to exercise his or her testamentary power of appointment, the fund held for that grandchild is to be distributed equally per stirpes to the grandchild's then living lawful descendants. If there are none, the fund is to be distributed equally among Grandparents' descendants, assuming for that purpose that Child A and Child B have died. Nevertheless, if the trustee deems a person incapable of using to good advantage the share otherwise receivable in default of a grandchild's testamentary direction, the trustee may dispose of the unqualified person's share among any of the remaining of Grandparents' descendants in such proportions as the trustee deems proper. If any part of the principal of a fund becomes distributable to someone who has not attained age 21, the trustee is to hold that portion in trust for that person until he or she attains age 21.

Under Article I, paragraph (j), the trustee has the full power and authority to

PLR-105342-02

determine whether and in what proportions any receipts or disbursements are to be credited or charged to or apportioned between trust principal and income.

Under applicable local law governing the ascertainment of income and principal and the apportionment of receipts and expenses, a trust is to be administered with due regard to the respective interests of income beneficiaries and remaindermen. A trust is so administered with respect to the allocation of receipts and expenses if a receipt is credited or an expense is charged to income or principal or partly to each in accordance with the terms of the instrument. State Statute.

Corporate Trustee is now a trustee of the trusts. On Date 2, in response to the trustees' request for instructions relating to their authority to manage and invest the trust assets, Court issued First Order authorizing the trustees to: (1) invest the assets on a joint or pooled basis; and (2) retain professional investment managers having expertise in managing the type of investments appropriate to meet the investment objectives of a trust or joint investment fund, if the trustees deem it appropriate in accordance with the exercise of their fiduciary responsibility.

The trustees subsequently petitioned Court for instructions concerning the power to allocate expenses and receipts under Article I, paragraph (j). On Date 3, Court issued Second Order concluding that, pursuant to the express language of Trust, the trustees have the power and authority in the exercise of their fiduciary responsibilities to credit realized capital gains to income and to charge income expenses to principal.

Requested ruling

You have asked us to rule that the exercise of the trustee's discretion to allocate capital gain receipts to income and to charge certain income expenses to principal pursuant to Second Order does not adversely affect the trusts' status as exempt from the generation-skipping transfer tax.

Discussion

Section 2601 imposes a tax on every generation-skipping transfer.

Section 1433(b)(2)(A) of the Tax Reform Act of 1986 ("the 1986 Act") and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations provide that the generation-skipping transfer tax shall not apply to any generation-skipping 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).

PLR-105342-02

Section 26.2601-1(b)(1)(ii) provides that any trust in existence on September 25, 1985, will be considered an irrevocable trust except as provided in §§ 26.2601-1(b)(1)(ii)(B) or (C) (relating to property includible in the grantor's gross estate under sections 2038 and 2042).

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 the application of Chapter 13 by section 1433(b)(2)(A) of the 1986 Act, 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.

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 will not cause the trust to lose its exempt status. The regulation provides that the rules contained in the paragraph are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation- skipping transfer tax purposes.

Section 26.2601-1(b)(4)(i)(C) provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument will not cause an exempt trust to be subject to the provisions of chapter 13 if - (1) the judicial action involves a bona fide issue; and (2) The construction is consistent with a applicable state law that would be applied by the highest court of the state.

Section 26.2601-1(b)(4)(i)(D) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C)) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, 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.

Section 26.2601-1(b)(4)(i)(E), Example 9, considers a situation in which, in 1980, Grantor established an irrevocable trust under the terms of which trust income is payable to Grantor's child, A, for life, and upon A's death, the remainder is to pass to A's issue, per stirpes. Under applicable state law, unless the governing instrument provides otherwise, capital gain is allocated to principal. In 2002, the trust is modified to allow the trustee to allocate capital gain to income. The modification does not shift any beneficial interest in the trust to a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. In this

PLR-105342-02

case, the modification can only have the effect of increasing the amount distributable to A, and decreasing 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 cause the trust to be subject to the provisions of chapter 13.

In the instant case, Trust and Grandchild A Trust, Grandchild B Trust and Grandchild C Trust were irrevocable on September 25, 1985, and no additions, actual or constructive, have been made to Trust or Grandchild A Trust, Grandchild B Trust or Grandchild C Trust after that date. The judicial construction of Article I, paragraph (j), that the trustees are authorized under the provision to allocate capital gain receipts to income and charge certain income expenses to corpus, is consistent with the language of the provision and applicable state law.

Accordingly, based on the facts submitted and the representations made, we rule that the entry of the Second Order authorizing the trustees to allocate capital gain receipts to income and charge certain income expenses to corpus, and the trustees' exercise of discretion in accordance with the court order, will not adversely affect the status of Grandchild A Trust, Grandchild B Trust and Grandchild C Trust as exempt from generation-skipping transfer tax. Section 26.2601-1(b)(4)(i)(C). See also, § 26.2601-1(b)(4)(i)(E), Example 9.

Except as specifically ruled herein, we express no opinion on the federal tax consequences of the modification under the cited provisions or under any other provisions of the Code. Specifically, we express no opinion on the federal income and gift tax consequences of the modification.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,

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

Enclosure
Copy for section 6110 purposes