

## REG-103841-99

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking and notice of public hearing.

**SUMMARY:** This document contains proposed regulations relating to the application of the effective date rules of the generation-skipping transfer (GST) tax imposed under chapter 13 of the Internal Revenue Code. The proposed regulations provide guidance with respect to the type of trust modifications that will not affect the exempt status of a trust. In addition, the proposed regulations clarify the application of the effective date rules in the case of property transferred pursuant to the exercise of a general power of appointment. The proposed regulations are necessary to provide guidance to taxpayers so that they may properly determine if chapter 13 of the Code is applicable to a particular trust.

**DATES:** Written and electronic comments must be received by February 16, 2000. Outlines of topics to be discussed at the public hearing scheduled for March 15, 2000 at 10:00, must be received by February 23, 2000.

**ADDRESSES:** Send submissions to: CC:DOM:CORP:R (REG-103841-99), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-103841-99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at <http://www.irs.gov/taxregs/reglist.html>. The public hearing will be

held in room 2615, Internal Revenue Service Building, 1111 Constitution Avenue, NW, Washington, DC.

**FOR FURTHER INFORMATION CONTACT:** Concerning the proposed regulations, James F. Hogan, (202) 622-3090; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Michael L. Slaughter, (202) 622-7180 (not toll-free numbers).

### SUPPLEMENTARY INFORMATION:

#### *Background*

The GST tax provisions were enacted as part of the Tax Reform Act of 1986 (TRA), Pub. L. 99-514, 1986-3 (Vol. 1) C.B. 1, 634. Under section 1433(a) of the TRA, the GST tax generally applies to all generation-skipping transfers made after October 22, 1986, the date the TRA was enacted.

Section 1433(b)(2) of the TRA exempts transfers from certain trusts from the GST tax. Hereinafter, a trust that is exempt under section 1433(b)(2) is referred to as an "exempt trust."

First, under section 1433(b)(2)(A) of the TRA, the GST tax does not apply to any transfer from a trust that was irrevocable on September 25, 1985, to the extent the transfer is not made out of additions to the trust after September 25, 1985 (the day before the House Ways and Means Committee began considering the bill containing the GST provisions). Under §26.2601-1(b)(1)(ii) of the Generation-skipping Transfer Tax Regulations, a trust created on or before September 25, 1985, is considered irrevocable on that date unless: (1) the settlor retained a power that would cause the trust to be included in the settlor's gross estate for federal estate tax purposes by reason of section 2038 of the Code, if the settlor had died on September 25, 1985; or (2) the property held in the trust is a life insurance policy transferred by the insured and the insured possessed, on September 25, 1985, any incident of ownership that would have caused the value of the trust to be included in the insured's gross estate under section 2042 of the Code if the insured had died on September 25, 1985.

Second, under section 1433(b)(2)(B) of the TRA, as amended by the Technical and Miscellaneous Revenue Act of 1988, the GST tax does not apply to any generation-skipping transfer under a will or revocable trust executed before October 22, 1986, if the decedent died before January 1, 1987.

Third, under section 1433(b)(2)(C) of the TRA, the GST tax does not apply to any generation-skipping transfer under a trust to the extent such trust consists of property included in the gross estate of a decedent or reinvestments thereof, but only if the decedent was, on October 22, 1986, under a mental disability to change the disposition of the decedent's property and did not regain competence to dispose of the property before death.

Numerous taxpayers have requested private letter rulings regarding the effect that a proposed modification or construction will have on an exempt trust for GST tax purposes. In rulings in this area, the IRS has held that a modification will not cause the trust to lose its exempt status if the modification does not result in any change in the quality, value, or timing of any beneficial interest under the trust. Although the statute does not specifically address modifications to trusts that are exempt under section 1433(b)(2) of the TRA, Treasury and the IRS believe that a trust that is modified such that none of the beneficial interests change can be viewed as the same trust that was in existence on September 25, 1985.

The majority of the ruling requests received by the Service concern proposed modifications intended to enable the trust to adapt to changed circumstances or to enable the trustee to administer the trust properly. These proposed modifications often are not inconsistent with the purpose of the TRA effective date provisions. Accordingly, as discussed below, these proposed regulations adopt a more liberal standard with respect to changes that may be made to the trust without the loss of exempt status. Treasury and the IRS intend that the regulations, when finalized, provide sufficient guidance concerning modifications that the need for private letter rulings will be greatly diminished. Comments are requested regarding whether the proposed regulations will achieve this result.

In addition, the proposed regulations clarify the application of the effective date provisions when the exercise or lapse of a general power of appointment over an otherwise grandfathered trust results in property passing to a skip person.

### *Explanation of Provisions*

#### *1. Modifications to Trusts*

The proposed regulations provide guidance regarding the types of modifications, constructions, and settlements of controversies that will not cause a trust to lose its exempt status. However, the rules contained in these proposed regulations apply only for GST tax purposes. Thus, the rules do not apply in determining, for example, whether a modification will result in a gift for gift tax purposes, or may cause inclusion of the trust assets in the gross estate, or may result in the realization of gain for purposes of section 1001 of the Code.

Under the proposed regulations, a court order in a construction proceeding that resolves an ambiguity in the terms of a trust instrument will not cause the trust to lose its exempt status. The judicial action, however, must involve a bona fide issue and the court's decision must be consistent with applicable state law that would be applied by the highest court of the state. *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967). Construction proceedings determine a settlor's intent as of the date the instrument became effective, and thus, a court order construing an instrument that satisfies these requirements does not alter or modify the terms of the instrument.

Similarly, under the proposed regulations, a court-approved settlement of a bona fide controversy relating to the administration of a trust or the construction of terms of the governing instrument of a trust will not cause a trust to lose its exempt status. This will be the case, however, only if the settlement is the product of arm's length negotiations, and the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. See *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981); *Estate of Suzuki v. Commissioner*, T.C. Memo. 1991-624. For example, A and B are the

sole remainder beneficiaries of a trust established by their parent. They disagree as to the portion of the remainder each is entitled to under the terms of the trust when the trust terminates. A settlement dividing the corpus equally among A, B, and C, B's child and the grandchild of the parent who established the trust, would not be considered within the range of reasonable outcomes because C is not a potential remainderman under any construction of the trust agreement.

The proposed regulations also address the situation in which a trustee distributes trust principal to a new trust for the benefit of succeeding generations. In some cases, the governing instrument grants the trustee broad discretionary powers to distribute principal to or for the benefit of the trust beneficiaries, outright or in trust. Under these circumstances, distributions by the trustee to trusts for the benefit of trust beneficiaries will not cause the original trust or the new trusts to lose exempt status provided the vesting of trust principal is not postponed beyond the perpetuities period applicable to the original trust.

Finally, under the proposed regulations, a trust may be modified and remain exempt for GST purposes. The modification, however, must 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 must not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

#### *2. Exercise of a General Power of Appointment after September 25, 1985.*

In *Simpson v. United States*, 183 F.3d 812 (8th Cir. 1999), the decedent exercised a testamentary general power of appointment granted under a marital trust that was created in 1966. Pursuant to the decedent's exercise of the general power of appointment, the property passed to her grandchildren who were skip persons under section 2612. The court concluded that the transfer to the grandchildren was exempt from the GST tax under section 1433(b)(2)(A) of the TRA, because the transfer was "under a trust" that was irrevocable on September 25, 1985.

The facts in *Simpson* are similar to those presented in *Peterson Marital Trust v. Commissioner*, 78 F.3d 795 (2nd Cir. 1996). In *Peterson*, the decedent had a testamentary general power to appoint property in a pre-September 25, 1985 marital trust created under her husband's will. Rather than appointing the property outright, the taxpayer allowed the power to lapse and the property passed to her husband's grandchildren, who were skip persons under section 2612. The court concluded that the transfer was subject to the GST tax. The court noted that the effective date provisions in section 1433(b)(2) of the TRA were "designed . . . to protect those taxpayers who, on the basis of pre-existing rules, made arrangements from which they could not reasonably escape and which, in retrospect, had become singularly undesirable." *Peterson Marital Trust*, at 801 (footnote omitted). The court concluded that there was no basis to apply the protection provided in section 1433(b)(2) to the marital trust because the arrangement could have been changed to avoid the GST tax through the exercise of the decedent's general power of appointment.

Treasury and the IRS believe that there is no substantive difference between the situation in *Simpson* where property passed pursuant to the exercise of a general power of appointment and the situation in *Peterson Marital Trust* where property passed pursuant to a lapse of a general power of appointment. An individual who has a general power of appointment has the equivalent of outright ownership in the property. *Estate of Kruz v. Commissioner*, 101 T.C. 44, 50-51, 59-60 (1993). The value of the property subject to the general power is includible in the powerholder's gross estate at death under section 2041(a). In either case, the powerholder can avoid the consequences of the GST tax by appointing the property to nonskip persons. Therefore, as the court noted in *Peterson Marital Trust*, there is no basis for exempting such dispositions from the GST tax under the TRA effective date provisions.

Accordingly, the proposed regulations clarify that the transfer of property pursuant to the exercise, release, or lapse of a general power of appointment created in a pre-September 25, 1985 trust is not a transfer under the trust, but rather is a

transfer by the powerholder occurring when the exercise, release, or lapse of the power becomes effective, for purposes of section 1433(b)(2)(A) of the TRA.

### Special Analysis

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the regulations will be submitted to the Small Business Administration for comment on their impact on small business.

### Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely (in the manner described in ADDRESSES) to the IRS. Treasury and the IRS specifically request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for March 15, 2000 at 10:00 a.m. in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons that wish to present oral comments at the hearing must submit comments by February 16, 2000, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by February 23, 2000. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

### Drafting Information

The principal author of these proposed regulations is James F. Hogan, Office of the Chief Counsel, IRS. Other personnel from the IRS and Treasury Department participated in their development.

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### Proposed Amendments to the Regulations

Accordingly, 26 CFR part 26 is proposed to be amended as follows:

#### PART 26—GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1986

Par. 1. The authority citation for part 26 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. In §26.2600–1 the Table is amended under §26.2601 by revising the entry for paragraphs (b) and (b)(4) and adding an entry for paragraph (b)(5) to read as follows:

§26.2600–1. Table of contents.

§26.2601–1. *Effective dates.*

\* \* \* \* \*

(b) Exceptions

\* \* \* \* \*

(4) Retention of trust's exempt status in the case of modifications, etc.

(5) Exceptions to additions rule.

\* \* \* \* \*

Par. 3. Section 26.2601–1 is amended as follows:

1. Adding four sentences to the end of paragraph (b)(1)(i).

2. Redesignating paragraph (b)(4) as paragraph (b)(5).

3. Adding a new paragraph (b)(4).

4. Paragraph (c) is amended by adding a new sentence to the end of the paragraph.

The additions read as follows:

#### §26.2601–1 *Effective Dates.*

\* \* \* \* \*

(b) \* \* \*

(1) \* \* \*

(i) \* \* \* Further, the rule in the first sentence of this paragraph (b)(1)(i) 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. See §26.2601-1(b)(1)(v)(B) regarding the treatment of the release, exercise, or lapse of a power of appointment that will result in a constructive addition to a trust. See §26.2652–1(a) for the definition of a transferor.

\* \* \* \* \*

(4) *Retention of trust's exempt status in the case of modifications, etc.* (i) *In general.* This paragraph 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 under paragraphs (b)(1), (b)(2), or (b)(3) of this section (hereinafter referred to as an exempt trust) will not cause the trust to lose its exempt status. The rules contained in this paragraph (b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. The rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of section 1001 of the Code.

(A) *Trustee's discretionary powers.* The distribution of trust principal from an

exempt trust to a new trust will not cause the new trust to be subject to the provisions of chapter 13, if—

(1) The terms of the governing instrument of the exempt trust authorize the trustee to make distributions to the new trust without the consent or approval of any beneficiary or court, and

(2) The terms of the governing instrument of the new 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 of creation of the original trust, extending beyond any life in being at the date of creation of the original trust plus a period of 21 years, plus if necessary, a reasonable period of gestation. For purposes of this paragraph (b)(4)(i)(A), the exercise of a trustee's distributive power that validly postpones or suspends the vesting, absolute ownership, or power of alienation beyond the perpetuities period. If a trustee's distributive power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

(B) *Settlement.* A court-approved settlement of a bona fide controversy regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to the provisions of chapter 13, if—

(1) The settlement is the product of arm's length negotiations, and

(2) The settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement.

(C) *Judicial construction.* A judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error 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 applicable state law that would be applied by the highest court of the state.

(D) *Other changes.* A modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraphs (b)(4)(i)(A), (B), or (C) of this subsection) 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, but only if—

(1) 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

(2) 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.

(E) *Examples.* The following examples illustrate the application of this paragraph (b)(4). In each example, assume that the trust established in 1980 was irrevocable for purposes of §26.2601-1(b)(1)(ii) and that there have been no additions to any trust after September 25, 1985.

*Example 1. Trustee's power to distribute principal authorized under trust instrument.* In 1980, Grantor established an irrevocable trust (Trust) for the benefit of Grantor's child, A, A's spouse, and A's issue. At the time Trust was established, A had two children, B and C. A corporate fiduciary was designated as trustee. Under the terms of Trust, the trustee has the discretion to distribute all or part of the trust income to one or more of the group consisting of A, A's spouse or A's issue. The trustee is also authorized to distribute all or part of the trust principal to one or more trusts for the benefit of A, A's spouse, or A's issue under terms specified by the trustee in the trustee's discretion. Any trust established under Trust, however, must terminate 21 years after the death of the last child of A to die who was alive at the time Trust was executed. Trust will terminate on the death of A, at which time the remaining principal will be distributed to A's issue, per stirpes. In 2000, the trustee distributed part of Trust's principal to a new trust for the benefit of B and C and their issue. The new trust will terminate 21 years after the death of the survivor of B and C, at which time the trust principal will be distributed to the issue of B and C, per stirpes. The terms of the governing instrument of Trust authorize the trustee to make the distribution to a new trust without the consent or approval of any beneficiary or court. In addition, the terms of the governing instrument of the new trust do not extend the time for vesting of any beneficial interest in a manner that may post-

pone 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 Trust, extending beyond any life in being at the date of creation of Trust plus a period of 21 years, plus if necessary, a reasonable period of gestation. Accordingly, neither Trust nor the new trust will be subject to the provisions of chapter 13 of the Code.

*Example 2. Trustee's power to distribute principal pursuant to state statute.* In 1980, Grantor established an irrevocable trust (Trust) for the benefit of Grantor's child, A, A's spouse, and A's issue. At the time Trust was established, A had two children, B and C. A corporate fiduciary was designated as trustee. Under the terms of Trust, the trustee has the discretion to distribute all or part of the trust income or principal to one or more of the group consisting of A, A's spouse or A's issue. Trust will terminate on the death of A, at which time the trust principal will be distributed to A's issue, per stirpes. Under a state statute applicable to Trust, a trustee who has the absolute discretion under the terms of a testamentary instrument or irrevocable inter vivos trust agreement to invade the principal of a trust for the benefit of the income beneficiaries of the trust, may exercise the discretion by appointing so much or all of the principal of the trust in favor of a trustee of a trust under an instrument other than that under which the power to invade is created, or under the same instrument. The trustee may take the action either with consent of all the persons interested in the trust but without prior court approval, or with court approval, upon notice to all of the parties. The exercise of the discretion, however, must not reduce any fixed income interest of any income beneficiary of the trust and must be in favor of the beneficiaries of the trust. In 2000, the trustee distributes one-half of Trust's principal to a new trust that provides for the payment of trust income to A for life and further provides that, at A's death, one-half of the trust remainder will pass to B or B's issue and one-half of the trust will pass to C or C's issue. Because the state statute requires the consent of all of the parties, the transaction constitutes a modification of Trust. However, because the modification does not shift any beneficial interest in Trust to a beneficiary or beneficiaries who occupy a lower generation than the person or persons who held the beneficial interest prior to the modification, neither Trust nor the new trust will be subject to the provisions of chapter 13 of the Code.

*Example 3. Construction of an ambiguous term in the instrument.* In 1980, Grantor established an irrevocable trust for the benefit of Grantor's children, A and B, and their issue. The trust is to terminate on the death of the last to die of A and B, at which time the principal is to be distributed to their issue. However, the provision governing the termination of the trust is ambiguous regarding whether the trust principal is to be distributed per stirpes, only to the children of A and B, or per capita among the children, grandchildren, and more remote issue of A and B. The trustee files a construction suit with the appropriate local court to resolve the ambiguity. The court issues an order construing the instrument to provide for per capita distributions to the children, grandchildren, and more remote issue of A and B living at the time the trust terminates. The court's construction is consistent with applicable state law as it

would be interpreted by the highest court of the state and resolves a bona fide controversy regarding the proper interpretation of the instrument. Therefore, the trust will not be subject to the provisions of chapter 13 of the Code.

*Example 4. Change in trust situs.* 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. The provisions of the trust do not specify that any particular state law is to govern the administration and construction of the trust. In State X, the common law rule against perpetuities applies to trusts. In 2000, a State Y bank is named 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 this case, however, in view of the terms of the trust, 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 beneficial 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 of the Code. If, in this example, as a result of the change in situs, State Y law governed such that the time for vesting was extended beyond the period prescribed under the terms of the original trust instrument, the trust would not retain exempt status.

*Example 5. Division of a trust.* In 1980, Grantor established an irrevocable trust for the benefit of his two children, A and B, and their issue. Under the terms of the trust, 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 2000, 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 for A and A's issue provides that the trustee has the discretion to distribute trust income and principal to A and A's issue in such amounts as the trustee deems appropriate. On A's death, the trust principal is to be distributed equally to A's issue, per stirpes. The trust for B and B's issue is identical (except for the beneficiaries), and terminates at B's death at which time the trust principal is to be distributed equally to B's issue, per stirpes. 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 of the Code.

*Example 6. Merger of two trusts.* In 1980, Grantor established an irrevocable trust for Grantor's child and the child's issue. In 1983, Grantor's spouse also established a separate irrevocable trust for the benefit of the same child and issue. The terms of the spouse's trust and Grantor's trust are identical. In 2000, the appropriate local court approved the merger of the two trusts into one trust to save administrative costs and enhance the management of the investments. The merger of the 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 merger. In addition, the merger 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 that resulted from the merger will not be subject to the provisions of chapter 13 of the Code.

*Example 7. Modification that does not shift an interest to a lower generation.* In 1980, Grantor established an irrevocable trust for the benefit of Grantor's grandchildren, A, B, and C. The trust provides that income is to be paid to A, B, and C, in equal shares for life. The trust further provides that, upon the death of the first grandchild to die, one-third of the principal is to be distributed to that grandchild's issue, per stirpes. Upon the death of the second grandchild to die, one-half of the remaining trust principal is to be distributed to that grandchild's issue, per stirpes, and upon the death of the last grandchild to die, the remaining principal is to be distributed to that grandchild's issue, per stirpes. In 2000, A became disabled. Subsequently, the trustee, with the consent of B and C, petitioned the appropriate local court and the court approved a modification of the trust that increased A's share of trust income. The modification does not shift a portion of the income interest to a beneficiary who occupies a generation lower than the generation occupied by A, B and C, and does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Accordingly, the trust as modified will not be subject to the provisions of chapter 13 of the Code. However, the modification increasing A's share of trust income is a transfer by B and C to A for federal gift tax purposes.

(ii) *Effective date.* The rules in this paragraph (b)(4) are effective as of [THE DATE OF PUBLICATION IN THE FEDERAL REGISTER AS A FINAL REGULATION].

\* \* \* \* \*

(c) \* \* \* The last four sentences in paragraph (b)(1)(i) of this section are effective as of November 18, 1999.

Robert E. Wenzel,  
Deputy Commissioner of  
Internal Revenue.

(Filed by the Office of the Federal Register on November 17, 1999, 8:45 a.m., and published in the issue of the Federal Register for November 18, 1999, 64 F.R. 62997)