Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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November 9, 1999

LEGEND:

Husband =
Wife =
Bank =

Trust =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Date 1 =
X =
Y =
Z =

Dear :

This is in response to your authorized representative's letter dated May 26, and prior correspondence, in which rulings were requested on the estate, generation-skipping, and income tax consequences of a Trust provision regarding the removal and replacement of trustees.

The facts and representations submitted are as follows:

In Year 1, Husband and Wife created an irrevocable trust (Trust) for the benefit of their children and grandchildren. Husband and Wife filed gift tax returns reporting the transfer to the Trust as a completed gift for federal gift tax purposes.

Under the terms of the Trust, the trustees, in their discretion, may accumulate or pay the annual net income, in such proportions as they may determine, for the benefit of the children or the issue of the children of Husband and Wife, subject to certain limitations on the amount each one may receive in any given year, and also subject to restrictions based upon the ages of the beneficiaries during any given year. The Trust will terminate upon the earlier of (i) the 32nd birthday of all of the issue of the children of Husband and Wife or (ii) 21 years after the death of the last surviving child of Husband and Wife. At termination, Trust assets will be distributed outright to the issue of the children of Husband and Wife.

The original trustees of the Trust were X, Husband's attorney, who drafted the Trust agreement, and Bank. Article 8 of the Trust agreement provides for successor trustees as follows:

> If [X] shall resign or cease to serve as one of the TRUSTEES hereunder, then [Y] shall serve as one of the TRUSTEES in his place, and if [Y] shall be unable, resign or cease to serve as one of the TRUSTEES hereunder, then [Z] shall serve in his place.
>
> In the event that [Bank] shall resign or cease to serve as one of the TRUSTEES hereunder, then [another bank] shall serve as one of the TRUSTEES hereunder.
>
> Notwithstanding the foregoing, [Husband], or in the event of his death, [Wife], shall have the right of removing without cause either one or both of the TRUSTEES or their or its successors, whether named hereinbefore or not, provided he or she shall immediately substitute a successor for either another person or party, <u>one of whom or which is neither the GRANTOR nor a "related or subordinate party" as that term is defined for Federal Tax purposes.</u> [Emphasis added.]

Article 14 of the Trust agreement provides, in relevant part:

> This Agreement and the trusts hereby created shall be irrevocable and shall not be altered, amended, revoked, or terminated, in whole or in party [sic] by the GRANTORS.... The GRANTORS hereby renounce for themselves and their estates any interest, either vested or contingent, including any reversionary right or possibility or reversion in the corpus and income of the Trusts, and any power to determine or control, by alteration, amendment, revocation, or termination, or otherwise, the beneficial enjoyment of the corpus or income of the Trusts.

The issue presented by this ruling request involves the proper interpretation of Article 8 of the Trust agreement cited above. One interpretation of Article 8 is that

Husband (or, if Husband is deceased, Wife) has the power to remove the trustees and appoint himself (or herself) or a related or subordinate party as trustee. Under this interpretation, Husband (or Wife) would be deemed to possess the powers of the trustees and, as a consequence, the value of the Trust assets would be includible in Husband's (or Wife's) gross estate under § 2036 and/or § 2038 of the Internal Revenue Code, and the Trust would not be exempt from the generation-skipping transfer tax under the provisions of § 26.2601-1(b)(1)(ii)(B) of the Generation-Skipping Transfer Tax Regulations. Additionally, the Trust would be treated as a grantor trust under the provisions of § 674(a).

In Year 5, Bank, as trustee, petitioned the common pleas court of the probate division of county court (court) for summary judgment, declaring as a matter of law that the last paragraph of Article 8 "restricts and limits the right of [Husband] and [Wife] to name as successor trustees only those persons, none of whom are either the grantor or a 'related or subordinate party' as that term is defined for federal tax purposes." [Emphasis added.] The petition alleged that it was not the intent of the grantors to retain the power to remove the trustees and appoint themselves or related or subordinate parties as trustees, and that the wording of the last paragraph of Article 8 contains a scrivener's error.

On Date 1, the court entered its order that the last paragraph of Article 8 of the Trust agreement is construed to read as follows:

> Not withstanding the foregoing, [Husband], or in the event of his death, [Wife], shall have the right of removing without cause either one or both of the TRUSTEES or their or its successors, whether named hereinbefore or not, provided he or she shall immediately substitute as successor or successors another person or persons or party or parties none of whom or which is either the GRANTOR or a "related or subordinate party" as that term is defined for Federal Tax purposes. [Emphasis added.]

The court's order further states that "such construction of the Trust shall be effective as of the day the Trust Agreement was executed."

It is represented that no property has been added to the Trust since its initial funding, and that no distributions of income or principal have been made from the Trust since before September 25, 1985.

The following rulings are requested:

1. None of the assets of the Trust will be includible in the gross estate of either Husband or Wife under § 2036 or § 2038.

2. The Trust was irrevocable on September 25, 1985, and, accordingly, the provisions of Chapter 13 do not apply to any generation-skipping transfers from the Trust, except to a pro rata portion of any such transfer if any additions are made to the Trust after September 25, 1985.

3. None of the Trust income is taxable to Husband by reason of § 674.

Ruling #1. Section 2001(a) of the Internal Revenue Code imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2036(a)(2) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which the decedent has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death, the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Section 20.2036-1(b)(3) provides that the phrase “right... to designate the person or persons who shall possess or enjoy the transferred property or the income therefrom” includes a reserved power to designate the person or persons to receive the income from the transferred property, or to possess or enjoy nonincome-producing property during the decedent’s life. With respect to such a power, it is immaterial whether the power was exercisable alone or only in conjunction with another person or persons, whether or not having an adverse interest. It is also immaterial in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent. The phrase does not apply to a power held solely by a person other than the decedent, but, if the decedent reserved the unrestricted power to remove or discharge a trustee at any time and appoint himself as trustee, the decedent is considered as having the powers of the trustee.

Section 2038(a)(1) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.

Section 20.2038-1(a)(3) provides that if the decedent had the unrestricted power to remove or discharge a trustee at any time and appoint himself trustee, the decedent is considered as having the powers of the trustee.

Rev. Rul. 95-58, 1995-2 C.B. 191, holds that an individual is not treated as possessing the trustee's powers when the individual can remove and replace a trustee and appoint an individual or corporate trustee that is not related or subordinate to the individual (within the meaning of § 672(c)).

In Commissioner v. Estate of Bosch, 387 U.S. 456 (1967), the Supreme Court held that where the issue involved is the determination of property interests for federal estate tax purposes, and the determination is based on state law, the highest court of the state is the best authority on its own law. The Service, however, is not bound by a lower court decision. If there is a decision by a lower court, then the federal authority must apply what it finds to be state law after giving "proper regard" to the state trial court's determination and to relevant rulings of other courts of the state. In this respect, the federal agency may be said, in effect, to be sitting as a state court.

In Domo v. McCarthy, 66 Ohio 3d 312, 612 N.E. 2d 706 (1993), the Ohio Supreme Court stated, "We are mindful that one of the fundamental tenets for the construction of a will or trust is to ascertain, within the bounds of law, the intent of the grantor or settlor." The court also indicated that when the language of the trust instrument is uncertain or ambiguous, the court may consider extrinsic evidence to ascertain the grantor's intent.

In the present case, an ambiguity results when the last paragraph of Article 8 is interpreted to mean that the grantors have the power to remove the trustees and to appoint themselves or persons related or subordinate to themselves and Article 8 is then read in conjunction with Article 14, in which the grantors renounce any power to determine or control the beneficial enjoyment of the corpus or income of the Trust. In connection with its petition, Bank presented to the court various documents, correspondence, and affidavits which showed that Husband and Wife never intended to retain any powers over the Trust, including trustee removal and replacement powers, which would subject the Trust assets to inclusion in their gross estates, and that X believed that he had drafted the Trust agreement in a manner which was consistent with the grantors' intent.

We believe that the court's judgment resolving the ambiguity between Article 8 and Article 14 is consistent with applicable State law. Therefore, based on the facts and documents submitted and representations made, we conclude that none of the assets of the Trust will be includible in the gross estate of either Husband or Wife under § 2036 or § 2038.

Ruling #2. Section 2601 provides that a tax is imposed on every generation-

skipping transfer (GST). Section 2611 defines the term "generation-skipping transfer" to mean (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Section 2612(b) defines the term “taxable distribution” to mean any distribution from a trust to a skip person (other than a taxable termination or a direct skip). Section 2612(a)(1)(A) provides that a taxable termination occurs when an interest in a trust terminates, such as by death and, thereafter, only skip persons have an interest in the trust property.

Section 2613(a)(1) defines the term “skip person” as including a natural person assigned to a generation that is two or more generations below the generation assignment of the transferor.

In this case, Trust is a generation-skipping trust because it provides for distributions to persons that are two or more generations below the grantors’ generation.

Section 1433(b)(2)(A) of the Tax Reform Act of 1986 (Act) and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations provide that the generation-skipping transfer tax (GSTT) 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).

Section 26.2601-1(b)(1)(ii)(B) provides that for GSTT purposes, a trust is not an irrevocable trust to the extent that, on September 25, 1985, the settlor held a power with respect to such trust that would have caused the value of the trust to be included in the settlor’s gross estate for Federal estate tax purposes by reason of section 2038 (without regard to powers relinquished before September 25, 1985) if the settlor had died on September 25, 1985.

A modification of a generation-skipping trust that is otherwise exempt under the Act and the GSTT regulations will generally result in a loss of its exempt or “grandfathered” status if the modification changes the quality, value, or timing of any powers, beneficial interests, rights, or expectancies originally provided for under the terms of the trust.

In the present case, the Trust was irrevocable, according to its terms, on September 25, 1985. Pursuant to the court judgment, with which we agree, at no time did the grantors have a power with respect to the Trust that would have caused the value of the Trust to be included in their gross estates under § 2038. It is represented that no additions have been made to the Trust since before September 25, 1985. Moreover, the judgment of the court merely resolves an ambiguity with respect to certain Trust terms and does not result in any change to the quality, value or timing of

any powers, beneficial interests, rights, or expectancies originally provided for under the terms of the Trust.

Therefore, based on the facts and documents submitted and representations made, we conclude that the provisions of Chapter 13 (the GSTT) do not apply to any generation-skipping transfers from the Trust, except to a pro rata portion of any such transfer if any additions are made to the Trust after September 25, 1985.

Ruling #3. Section 671 provides that where the grantor or another person is treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under Chapter 1 of the Internal Revenue Code in computing taxable income or credits against the tax of an individual.

Generally, a grantor is treated as the owner of any portion of a trust in which the grantor has certain powers or interests described in §§ 673 through 677.

Section 674(a) provides the general rule that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the principal or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

Section 674(c) provides that the general rule of § 674(a) does not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees (none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries.

Section 1.674(d)-2(a) provides that a power in the grantor to remove, substitute, or add trustees (other than a power exercisable only upon limited conditions which do not exist during the taxable year, such as the death or resignation of, or breach of fiduciary duty by, an existing trustee) may prevent a trust from qualifying under § 674(c). If the grantor's power to remove, substitute, or add trustees is limited so that its exercise could not alter the trust in a manner that would disqualify it under § 674(c), the power itself does not disqualify the trust from the application of § 674(c).

In the present case, based on the judgment of the court construing Article 8 of Trust, Husband (or, if he is deceased, Wife) has the power to remove without cause either one or both of the trustees or their successors, provided he or she shall immediately substitute as successor or successors another person or persons or party

or parties none of whom or which is either the grantor or a “related or subordinate party” as that term is defined for federal tax purposes. Accordingly, the power of Husband or Wife to remove and replace the trustee or trustees is a power, the exercise of which could not alter the Trust in a manner that would disqualify it under § 674(c), and the power itself does not disqualify the Trust from the application of § 674(c).

Therefore, based on the facts and documents submitted and representations made, we conclude that none of the Trust income is taxable to Husband (or Wife) by reason of § 674.

Except as ruled above, we express or imply no opinion concerning the federal tax consequences of the situation described above under the cited provisions of the Code or any other provisions of the Code.

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.

In accordance with the power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

Sincerely yours,

Assistant Chief Counsel
(Passthroughs & Special Industries
By Katherine A. Mellody
Senior Technician Reviewer, Branch 4

Enclosure
Copy for § 6110 purposes